

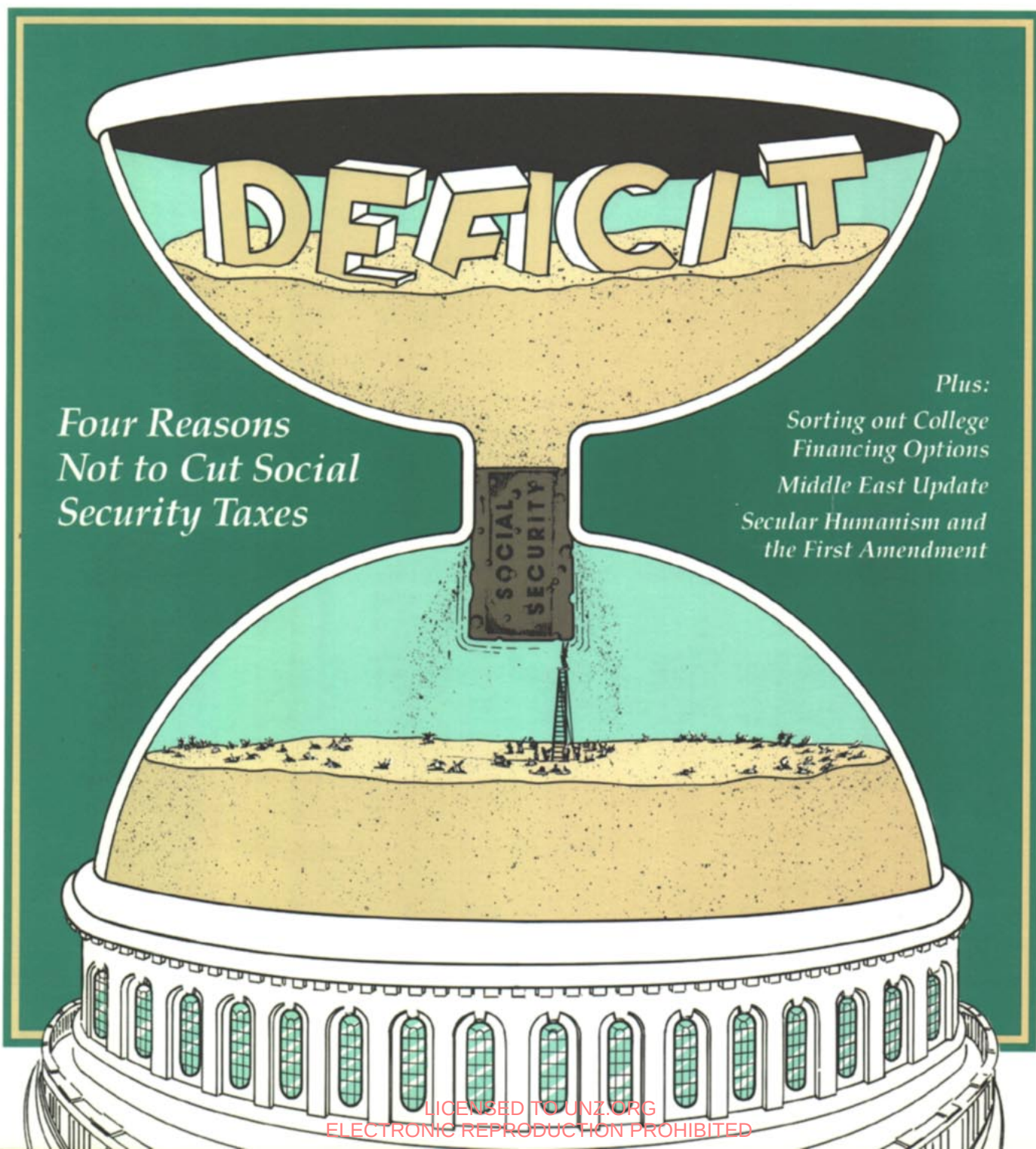
Four Dollars

T H E

Spring 1990

BROOKINGS

R E V I E W



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Not to Cut Social
Security Taxes*

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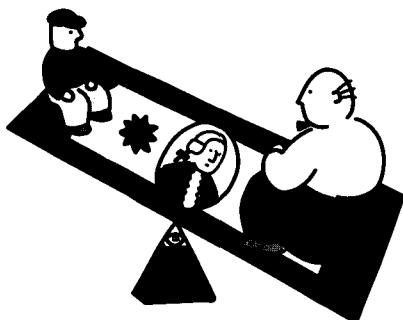
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BROOKINGS
R E V I E W

Spring 1990 Vol. 8, No. 2



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Delight at Finding the Culprit

I was delighted to see Margaret Blair's article, "A Surprising Culprit Behind the Rush to Leverage," in the winter issue of the *Brookings Review*, especially since I have toiled in the same vineyard. Ms. Blair's title echoes the reactions of my hard-boiled financial market colleagues: surprise at a link between higher leverage and higher (real) interest rates. As an aside, this link probably has a dual in the form of a backward-bending savings function so that higher real interest rates in the relevant range have inhibited rather than encouraged personal saving. I haven't had the courage to confront too many financial types with that one.

Neal M. Soss
Managing Director and Chief Economist
The First Boston Corporation

Doomsayer Description Challenged

The recent article by Roger Conner (Fall 1989) described me (among other people) as a doomsayer about U.S. demography. This is sheer invention. I challenge Mr. Conner to find a single word that I have ever written which takes a negative view towards the U.S. future with regard to demographic effects or anything else (except the ill effects of exaggeration and untruth in the media). And he is even further wrong when he suggests that I am in favor of government intervention to do something about demographic trends.

This making-up of supposed facts out of whole cloth may assist you to credit my assertion that the rest of Mr. Conner's article is grossly wrong about the nature of economic thinking, as well as demographic fact, in many places. Here, as elsewhere, Mr. Conner does not abide by the rule that advocacy must be truthful — not only in not being controvertibly wrong, but in telling the whole truth rather than just part of it. I had not expected to see this in the pages of a publication from Brookings.

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Late last year Senator Daniel Patrick Moynihan rebelled against continued use of the surplus in the Social Security trust funds to finance the deficit in the government's general operating budget. That practice, Moynihan said, "masks the true size of the budget deficit and perverts the original purpose of the surpluses." To end what he called the "thievery," the *New York Democrat* proposed that the increases in the Social Security payroll tax scheduled for 1990 be repealed and that the rate be rolled back again in 1991, putting the public pension system back on a "pay-as-you-go" basis.

Moynihan's proposal has touched off a spirited debate, not only about the proper use of the Social Security surplus and the size of the budget deficit, but also about the Social Security system itself, the goals of economic policy, and budget politics. Following are four separate perspectives on Senator Moynihan's proposal; the contributors are Alice Rivlin, Ralph Bryant, Charles Schultze, and Joseph White and Aaron Wildavsky.

Four Reasons Not to Cut Social Security Taxes

What Kind of Social Security System?

Alice M. Rivlin

Starting the Social Security system more than half a century ago was a farsighted, constructive policy of which Congress and all Americans can be justly proud. It was a good idea and has been responsibly implemented.

The good idea was not just to tax working people to support income maintenance programs for the elderly and the disabled. It was to create a contributory social insurance system to which workers (and their employers) would contribute a fraction of their earnings and from which they would receive benefits related to their contributions. Within this framework, it was possible to make the benefits of low earners higher in relation to their contributions than those of high earners without appearing to be giving them charity. Although financed by a slightly regressive payroll tax, the Social Security system as a whole was progressive, but it was not welfare.

The contributory social insurance concept has proved extremely powerful. People have been willing to pay taxes into the system because they identified their future benefits with those levies. The existence of Social Security has raised the standard of living of older people dramatically and reduced the incidence of poverty among the aged from high levels to about the same as other groups in the population.

So long as the labor force was growing at fairly steady rates, it was feasible to run the Social Security system on a pay-as-you-go basis without doing visible violence to the contributory principle — and perfectly responsible to do so. The fact that benefits were essentially paid out of current taxes enabled the system to start up quickly. A system based on the government's power to tax needs only enough reserves to allow for unexpected developments in the economy. There is no danger, as there is with a company, that the government will go out of business and leave the pensioners without benefits. In fact, most Social Security beneficiaries have gotten back far more than they contributed, but few of them have known

that and even fewer have objected to it.

The big bulge of baby boomers moving through the system, however, made it necessary either to build reserves or to abandon the contributory concept in an obvious way. Sticking with pay-as-you-go through the baby boom bulge would necessitate a big increase in the payroll tax on workers about 2010 to pay the pensions of retiring baby boomers. Such a big jump in payroll tax rates would destroy the connection between contributions and benefits, make it obvious that the baby boomers had not paid their way, and turn Social Security into an ordinary income maintenance program — a program in which current taxpayers are obviously supporting current beneficiaries. (To be sure, if the baby boomers' benefits are paid by drawing down reserves, general taxes will still have to rise to redeem the bonds. But this general tax rise does not so directly undermine the contributory concept of Social Security.)

At the moment, we are in a fortunate position. The appropriate policy for maintaining a contributory Social Security system — a buildup of reserves to pre-fund the baby boomers' retirement claims — turns out to facilitate appropriate fiscal policy for the 1990s: a surplus in the unified budget. The only problem is that we have not achieved the unified budget surplus because the large deficit in the general fund more than offsets the surplus in Social Security.

Using the Social Security surplus to fund other programs, as Senator Moynihan has forcefully pointed out, is a breach of faith with payroll taxpayers who think they are contributing to their generation's retirement benefits. It also makes use of a regressive tax to fund the general expenses of government.

The only satisfactory way to correct these problems, however, is to reduce the deficit in the general fund.



ALICE M. RIVLIN

Returning to pay-as-you-go funding would necessitate a big increase in payroll taxes about 2010 to pay the pensions of baby boomers.

Senator Moynihan's proposal to roll back the payroll tax would have two undesirable effects. First, it would increase the unified budget deficit, initially by about \$55 billion. That would raise interest rates, discourage investment, and make the country more dependent than it already is on foreign capital. Second, returning to a pay-as-you-go system would risk turning Social Security from a contributory social insurance system into an income maintenance program. The big payroll taxes that would be necessary when the baby boomers retire would likely lead to intergenerational conflict, benefit cuts, and perhaps conversion of Social Security to a means-tested program. I believe the contributory social insurance concept has proved its value and should not be abandoned. □

Alice Rivlin, senior fellow in the Brookings Economic Studies program, is a former director of the Congressional Budget Office. She is currently at work on a book about the federal budget.

Effects on the Economy

Ralph C. Bryant

What are the likely macroeconomic consequences of Senator Moynihan's proposal for reducing the Social Security payroll tax? Assuming that the proposal is enacted but that no other changes are made in expenditures or tax rates, what will happen to economic activity, inflation, interest rates, and the U.S. external imbalance?

I have prepared some estimates of the likely changes using a short-cut analytical procedure for obtaining model-based predictions. The raw material for the procedure is a set of standardized simulations from several different multicountry macroeconomic models. The models are diverse — none is fully reliable — and yield predictions that differ significantly from each other. The estimates are thus, at best, rough orders of magnitude. Yet, despite the uncertainty about the appropriateness of any individual model, these estimates from a variety of models are, taken together, indicative of the likely consequences of the Moynihan proposal. I know of no other analytical procedure that yields more reliable estimates.

Two sets of estimates were produced. The first shows the effects of the Moynihan proposal based on the assumption that the Federal Reserve makes no changes in monetary policy. The second set makes the more realistic assumption that the Federal Reserve pursues an incrementally restrictive monetary policy to offset the stimulative effects on output and prices of an incrementally expansive fiscal policy.

The reduction in Social Security payroll taxes without any change in the money stock would have the typical consequences of stimulative fiscal policy. Real



RALPH C. BRYANT

The proposal's effects on the economy would be precisely the opposite of what the country needs to increase national saving and investment.

gross national product would rise by some $\frac{3}{4}$ to $1\frac{1}{2}$ percent relative to what it otherwise would have been. The price level, and therefore inflation, would be higher. Nominal short-term and long-term interest rates would rise, perhaps by more than a percentage point. Even real (inflation-adjusted) interest rates could rise perceptibly.

The budget deficit would rise sharply, by $\frac{1}{3}$ to $\frac{3}{4}$ percent of GNP in the second year and by some $\frac{3}{4}$ to $1\frac{1}{2}$ percent of GNP after several more years. In current dollars, that translates into an increase in the deficit of \$25–50 billion in 1991 and \$60–120 billion by 1995–96. The dollar would probably appreciate by a modest amount, while the current account deficit would rise by increasing amounts to some \$20–85 billion by 1995–96.

Assessment of whether these incremental changes in the economy are good or bad depends, of course, on whether the economy would be buoyant or weak in the absence of the payroll tax deductions. Even if the economy would otherwise be weak, however, any policy stimulus to aggregate demand should preferably come from monetary rather than fiscal policy. Fiscal stimulus would cause higher interest rates and larger budget and current account deficits than monetary stimulus would, with clearly inferior results for national saving and domestic investment.

The Federal Reserve tries to keep nominal aggregate demand growing at a pace consistent with the economy, avoiding either a recession or a resumption of higher inflation. The most plausible assumption to make about Federal Reserve policy, therefore, is that the Federal Open Market Committee would respond to enactment of the Moynihan proposal by tightening monetary policy (somewhat in the first year, by a larger amount in subsequent years). Such an offsetting policy would restrain price increases, but it would lead to dra-

matically higher nominal interest rates, especially for short-term rates in 1991. Real interest rates could rise by well over 100 basis points. The added interest costs of servicing the government's debt would lead to still more ballooning of the budget deficit, a sizable additional appreciation of the dollar in exchange markets, and still further worsening of the external imbalance.

The effects of the Moynihan tax reductions for interest rates, exchange rates, and the budget deficit — even by themselves, but especially if heightened by the likely tightening of Federal Reserve policy — would be precisely the opposite of what the country needs to increase national saving and domestic investment. Consumption would rise, and investment would be markedly lower than what would otherwise occur. If the current generation of political leaders in this country seriously cares about the future welfare of their children and their children's children (including the equity and efficiency of the then-prevailing Social Security system), they will not adopt Senator Moynihan's proposal.

It is often said the proposal is intended merely to catalyze a better debate about budget and Social Security priorities and that enactment of the payroll tax reductions would subsequently force the needed changes in government spending and other (nonpayroll) tax policies. Such an outcome is conceivable. But at the least this line of reasoning is dangerous — tantamount to the argument that, when one's car is stuck in three feet of mud at the edge of a swamp, the recommended way to get out is to drive still deeper into the swamp to dramatize the seriousness of the situation. □

Ralph C. Bryant, a senior fellow in Economic Studies, has focused his recent research on macroeconomic interactions among major industrial nations, analyzed by comparing and evaluating alternative macroeconomic models. Details of the estimates summarized here can be obtained by writing *The Brookings Review*.

Effects on National Saving

Charles L. Schultze

Whether Social Security continues to be funded on an actuarial basis or is converted back to a pay-as-you-go system, as Senator Moynihan proposes, two important facts will not change. First, starting early in the next century as the baby boomers retire, Social Security benefit payments will grow substantially as a percentage of national income. Second, one way or the other, the taxpayers of the 21st century are going to face higher taxes to pay for those benefits — some combination of payroll taxes and the general revenues needed to pay interest on the Treasury securities held by the Social Security fund.

That burden can be lessened only if the current



CHARLES L. SCHULTZE

The whole point of a surplus in the Social Security trust funds is defeated if the rest of the budget does not approach a balance.

working generation begins to pay now for its future retirement benefits. But the only way a whole generation can provide today for tomorrow's retirement benefits is to take the steps necessary to increase national saving, devote the higher saving to investment in productive assets, and so raise the future national income out of which the higher taxes will be paid.

The additional national saving could be generated in two ways. A pay-as-you-go Social Security system could be combined with a substantial surplus in the rest of the budget, that is, in the general operating accounts. Alternatively, the government could balance the operating budget and run an actuarially funded Social Security system; the necessary budget surplus would show up in the Social Security trust funds and be invested in Treasury securities.

In either case the *overall* federal budget would be in surplus. Each year a significant amount of federal debt held by the public would be retired. Those sums would then be available to supplement private saving; the rate at which the nation was accumulating productive wealth would rise; and the future level of national productivity and output would be higher than what otherwise would have been the case. This generation would indeed be paying for its own Social Security benefits, rather than shifting the burden to the future.

Clearly the whole purpose of building reserves in the Social Security trust funds is defeated if the surplus is not accompanied by something approaching balance in the rest of the budget. And when, under budget accounting, the mounting surplus in the Social Security trust funds actually masks and in effect helps justify a large deficit in the remainder of the budget, the inequity imposed on the next generation is compounded by an inequity imposed on the current gener-

ation. The capping of the payroll tax at \$50,000 of wage income is justified when it is a payment to a retirement system whose benefits are progressive and similarly capped. But it is an inequitable way to levy a tax to pay for the general operating expenses of government.

Senator Moynihan's proposal rightly calls attention to this double inequity in current budget policy. But it would deal with the one inequity in a way that sharply worsens the other. In the process it would greatly exacerbate America's already serious problem of undersaving, underinvesting, and undercompeting.

After several years the Moynihan proposal would cost some \$60 billion annually in lost payroll tax revenue. Because this initial increase in the budget deficit would result in higher interest rates and a higher federal debt, federal interest outlays would grow sharply. The combination of lower tax revenues and increased interest outlays would add \$90-\$100 billion a year to the budget deficit.

National saving in the United States — which is equal to private saving less the amount absorbed in financing the overall budget deficit — would fall still further below the abysmal level to which it has sunk in the past decade. National saving in 1989 was only 3½ percent of national income, far below its historical level in our country and the lowest saving rate of any modern industrial nation, in most cases by a wide margin.

Would matters be set straight if the payroll tax deduction were balanced with an offsetting increase in some other tax that did not have the regressive character of the payroll tax? There are two problems with that scenario. First, except for Senator Hollings, there has been a deafening silence from both parties when it comes to proposals for a specific, offsetting tax increase. Second, if such a tax were proposed and enacted, it would very probably remove for the next decade any chance of raising the taxes that are needed to deal with the current and projected budget deficits.

I realize that for the moment lip-reading has substituted for real deficit reduction. But as Europe reinvigorates itself by forming a true common market and opening economic ties with Eastern Europe, and as Japan continues to grow in productivity, technological capability, and market power, I continue to hope, perhaps naively, that the United States will finally take the painful steps to end its own decade-long consumption binge and restore its national saving, investment, and productivity growth to levels worthy of a modern industrial power. One component of that solution will have to be a substantial tax increase dedicated not to lowering taxes elsewhere but to reducing the budget deficit, eventually to the point where it comes close to balance without reliance on the surplus in the Social Security funds. □

Charles L. Schultze, director of Economic Studies at Brookings, was chairman of the Council of Economic Advisers under President Carter.

Pretzel Logic

Joseph White and Aaron Wildavsky

The Moynihan proposal creates some unlikely alliances, as people choose the same side for widely different reasons. We, for example, have grave doubts about common understandings of Social Security and are even more skeptical about calls for a surplus in the federal budget. The relation between extra savings and greater growth is not as strong as many economists would have it (if it were, people might invest more on their own). There are contradictions between encouraging private savings, or increasing public investment, and increasing public savings by running a surplus. And when economists say the government doesn't know how to encourage private savings but does know how to run a federal surplus, we wonder which political system they have been watching for the past decade. Yet it is precisely because we think a surplus is a hopeless goal that we believe Moynihan's plan can help no one.

One can endlessly argue the proposal's implications for Social Security, and to no real point. Surely it can't make Social Security more secure. Whatever happens, a government-run plan is by far the most sensible way to guarantee pensions; and from any budget position, whether balanced or in deficit, a \$60 billion Social Security surplus increases national savings by \$60 billion. Eliminating the surplus, *ceteris paribus*, reduces savings by \$60 billion. In fact, Moynihan's and a raft of other proposed Social Security maneuvers, from proposals to take the surplus out of the Gramm-Rudman calculations to the administration's debt reduction fund, aren't really about Social Security at all. They are



JOSEPH WHITE

Throughout the decade budget balancers tried to make the deficit seem bigger by exaggerating its short-term evils.

all part of the politics of deficit reduction.

As author of the Democratic minority report of the National Economic Commission in 1989, Senator Moynihan strongly endorsed running a budget surplus. He argued a surplus was not just good economics, but the only plausible goal politically. In essence, in his own words from that report, the only way to eliminate the deficit is to aim high: "After a decade of prolonged and stultifying debate the budget remains unbalanced. And it is likely to remain unbalanced unless and until there is seen to be something larger at stake than merely the performance of duty. Dull duty: virtue's residue, reason's remnant. We need something more; something to stir the blood. Something touched with civic courage and national achievement. A budget surplus."

He followed this statement with a direct threat: that if the government did not pursue that goal, the Democratic Congress would repeal the Social Security payroll tax increases. If the government is going to run a deficit, he wrote, it should not finance it with the regressive payroll tax.

There are two propositions here. First, the best way to eliminate the deficit is to make it seem bigger. That may sound strange, yet it has been a dominant theme in deficit politics since 1980. Throughout the decade budget balancers tried to make the deficit seem bigger by exaggerating its short-term evils. It was accused of causing hyperinflation; when inflation ended, of causing the recession; when the recession ended, of causing the strong dollar, then the weak dollar, and then again the strong dollar.

Some budgeteers even hoped for a stock market crash that would force the government to act, and saw the 1987 collapse as an opportunity. When that didn't work, perhaps because even after the crash the Dow-Jones index was still twice what it was before the deficit shot up, politicians and economists continued to wish for bad news. As Charlie Schultze has expressed it, "The crisis is there is no crisis."

Lacking an economic crisis, budget balancers tried to engineer a political crisis: the Gramm-Rudman-Hollings sequester. Assuming politicians would balance the budget if they were only scared enough, Gramm-Rudman gives them something to be scared of: remarkably dumb meat-ax cuts to discretionary spending programs.

In fact, there is little reason to believe that Gramm-Rudman forced politicians to reduce the deficit more than they would have without it. There is no doubt at all that the threat of sequester has not forced the nation's politicians to meet the deficit targets. Instead they have relied on luck (the one-year revenue bonus from tax reform), or changed the targets (in 1987), or rigged the numbers (all years, but especially the 1989 budget cycle).

Yet now Moynihan and the others who, in their varied ways, want to keep a Social Security surplus from

hiding the "true" size of the deficit are trying to "fix" Gramm-Rudman by making the deficit seem even bigger. Trying to make budgeting easier by making it harder is a lot like trying to improve a winless college football team by scheduling it to play against the Forty-Niners.

The reason it won't work is revealed by the second proposition implicit in Moynihan's proposal: that a balanced budget is not worth higher, regressive taxes. Most Democrats would add a lot of other policies to the list of unacceptable costs of balancing the budget: any reductions in Social Security benefits, poor peoples' programs, and the vast majority of general government activities. Republicans would veto and have vetoed tax increases of any sort, all but minimal defense cuts, and indeed cuts in most domestic spending. Neither side can impose its priorities on the other, and almost all the overlap has been used up in the substantial actions Congress has taken to reduce the deficit between 1982 and now.

No politician or analyst in recent years has produced a plan to balance the budget that anyone would call politically plausible. Dissensus, not cowardice, is the problem. Each side accuses the other of creating the deficit. Republicans blame the Democrats for the social spending commitments of the 1960s and 1970s, and Democrats blame Republicans for claiming the budget could be balanced with tax cuts and more defense spending in the 1980s. Since each party feels it is obviously right, each keeps thinking the other can be forced to give in.

Now Senator Moynihan's tax cut takes this ubiquitous illogic to its Democratic extreme. If President Bush defends the payroll tax, Democrats figure, how can he argue that other taxes are bad? (Easy. He said "no new taxes," remember?) Just as Ronald Reagan

thought a tax cut would reduce the deficit by making the need for spending cuts obvious, Moynihan believes his tax cut would reduce the deficit by revealing the need for tax hikes. At least Reagan's position was a bit less self-contradictory.

If the Moynihan proposal were to pick up momentum and look like it is going to pass, there would be a mad scramble to find countervailing revenues. At best that would use up every politically plausible revenue source that might otherwise be used to reduce the deficit. At worst, the proposal could pass without countervailing action. Then the deficit would rise; Gramm-Rudman politics would go on with increasing dishonesty. The overall tax burden would be more progressive, but since the deficit ultimately distributes income from middle-income people (who pay most of the taxes) to the better off (who receive the interest), the tax cut might not improve income distribution in our society at all.

What, then, is in this for the Democrats? Perhaps political advantage? Not so long as they claim their purpose is to reduce the deficit.

The Democrats' dilemma is simple. One of their basic principles holds that an activist government is necessary to redress the flaws of the market: maldistribution of income, nonprovision of public goods, and negative externalities. The deficit, or rather the consensus that it is evil, cripples activist government. The Democrats have no credible program because everything costs money, and they are part of the chorus that says the government doesn't have the cash.

Even if cutting the payroll tax were redistributive in the "right" way, it can only further cripple the activist government needed for most redistributive policies. If the Democrats could both pass the tax cut and convince themselves, economists, editorial writers, and voters (the easiest group) not to worry about the deficit, the party could gain some electoral advantage. If they can't do both, the tax cut just puts them deeper in the deficit trap.

It is easy to sympathize with politicians frustrated by 10 years of stultifying budget battles. Proposing to cut the Social Security payroll tax may show up the other side. But it embarrasses Democrats as well; undoes the triumphs of statesmanship to which Senator Moynihan contributed so much, the Social Security rescue and tax reform; imperils funding for his other great achievement, the beginning of child-oriented welfare programs; all with no prospect of reducing the deficit. For what? □

Joseph White is a research associate in Governmental Studies at Brookings. Aaron Wildavsky is professor of political science at the University of California, Berkeley. They are co-authors of *The Deficit and the Public Interest: The Search for Responsible Budgeting in the 1980s*, to be released by the University of California Press in April.



AARON WILDAVSKY

Trying to make budgeting easier by making it harder is like scheduling a winless college football team to play the Forty-Niners

Why We Should Stick with the Income Tax

Joseph A. Pechman

The federal income tax has been under attack by economists for more than a decade. The attack comes from two directions: supply-siders, who believe that progressive income taxation impairs economic incentives, and more traditional economists, who would substitute a progressive expenditure tax for the income tax. Support for the expenditure tax was once confined to a few members of the profession, including such distinguished names as John Stuart Mill, Irving Fisher, Nicholas Kaldor, and James Meade. Today, it is fair to say that many, if not most, economists favor the expenditure tax or a flat rate income tax. This group has joined the opponents of progressive taxation in the attack on the income tax.

Despite an incessant barrage from both groups, no country in the world is planning to abandon the income tax or is even considering a personal expenditure tax. Beginning with the U.S. tax reform in 1986, a wave of reform throughout the world has been aimed at improving the income tax, not at eliminating it. Tax preferences formerly regarded as sacrosanct are being removed, and there is a distinct movement toward

comprehensive income taxation. However, individual income tax rates are being cut, tax progressivity has been declining almost everywhere, and reliance on the income tax has been diminishing.

I applaud the base-broadening feature of the current tax reform movement, but the reduction in the redistributive effect of the income tax has gone too far. The progressivity of the U.S. tax system — never very pronounced, except during and immediately after the two world wars — has been declining for more than two decades. The Tax Reform Act of 1986 reversed this decline, but only slightly. Consequently, we have a long way to go to improve the equity of the tax system. I believe that can be done without punitive tax rates that will hurt economic incentives.

Growing Inequality

After several decades of relative stability, the distribution of before-tax income in the United States has become much more unequal in the last 10 years. Official statistics understate the increasing inequality. At the same time, the tax system as a whole — and the income tax in particular — has become less equalizing, so that the trend toward inequality is even more pronounced after tax than before tax.

The longest continuous and comparable series on income distribution available comes from the Census Bureau's annual Current Population Survey (CPS). The figures show that the share of total income received by

This article is an edited version of Joseph A. Pechman's presidential address to the American Economic Association, which he had drafted before his death on August 19, 1989. Senior fellow emeritus in the Brookings Economic Studies program, Pechman was also at work on four books, all investigating issues of tax policy. The Brookings Review is grateful to the AEA for its permission to print this article.

Table 1. Share of Income Going to the Wealthiest Tax Units

Year	Tax Units				
	Top 1%	Top 2%	Top 5%	Top 10%	Top 15%
1948	9.8%	13.4%	20.2%	27.9%	34.3%
1952	8.7	12.1	18.7	26.7	33.4
1963	8.8	12.3	19.4	28.2	35.5
1967	8.8	12.3	19.6	28.3	35.5
1972	8.0	11.4	18.7	27.8	35.4
1977	7.8	11.3	18.9	28.3	36.1
1981	8.1	11.5	19.0	28.6	36.5
1986	14.7	18.2	26.6	36.8	45.1

Source: *Statistics of Income*. Before-tax income includes realized capital gains in full but excludes transfer payments.

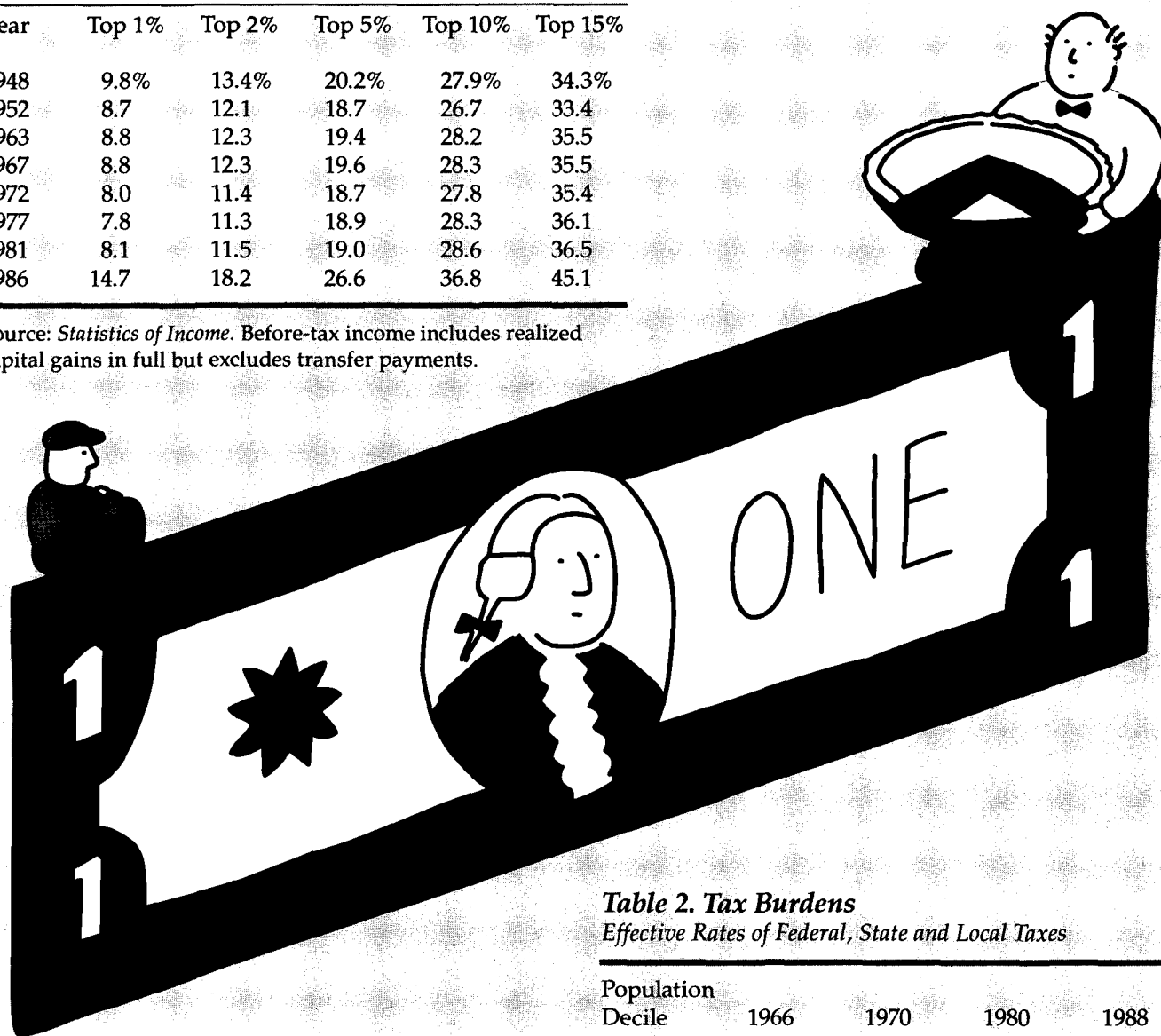


Table 2. Tax Burdens
Effective Rates of Federal, State and Local Taxes

Population Decile	1966	1970	1980	1988
Lowest	16.8%	18.8%	17.1%	16.4%
Second	18.9	19.5	17.1	15.8
Third	21.7	20.8	18.9	18.0
Fourth	22.6	23.2	20.8	21.5
Fifth	22.8	24.0	22.7	23.9
Sixth	22.7	24.1	23.4	24.3
Seventh	22.7	24.3	24.4	25.2
Eighth	23.1	24.6	25.5	25.6
Ninth	23.3	25.0	26.5	26.8
Highest	30.1	30.7	28.5	27.7
Top 5%	32.7	33.0	28.9	27.4
Top 1%	39.6	39.0	28.4	26.8
All deciles	25.2	26.1	25.3	25.4

Notes: The data assume that corporate income and property taxes are borne by capital income. The deciles are arrayed by comprehensive income, which includes transfer payments, employee fringe benefits, net imputed rent, and corporate earnings allocated to shareholders. The 1988 figures are projected from 1985 on the basis of Congressional Budget Office estimates of changes in effective federal tax rates. The calculations assume no change in effective state and local tax rates between 1985 and 1988. The lowest decile includes only units in the sixth to tenth percentiles; the figures for all deciles include negative incomes not shown separately.

Source: Brookings MERGE files.

the highest fifth of the nation's families fell from 1948 to 1952, remained unchanged between 1952 and 1981, and then rose from 1981 to 1988. In that year the top fifth received 44 percent of the income, the highest share ever recorded. The figures for the top 5 percent are similar, except that this group's share in 1988 had not quite recovered to the 1952 high.

It is well known that very high incomes are virtually unrepresented in the CPS distribution and that official census statistics greatly understate income inequality in any year. What is not recognized is that the CPS data greatly understate the *increase* in inequality that has occurred during the 1980s because very high incomes have been increasing much faster than the incomes in the lower part of the distribution. This phenomenon can be seen by examining changes in the shares of the top income recipients reported in the annual *Statistics of Income*, published by the Internal Revenue Service (see table 1, page 10).

Like the CPS data, the tax data show that the very rich in the United States, defined as either the top 1 or the top 5 percent of the income distribution, enjoyed about the same proportion of total income throughout the 1950s, 1960s, and 1970s, but that their share rose in the 1980s. From 1952 to 1981, the share of the top 1 percent of the tax units ran between 8 and 9 percent of the total income reported on tax returns. After 1981, that share skyrocketed, reaching 14.7 percent in 1986. The same trends are shown by the top 2, 5, 10, and 15 percent of the tax units.

Much of this increase reflects the large increase in realized capital gains that accompanied the bull market. According to *Statistics of Income*, the shares of adjusted gross income excluding capital gains rose only moderately, increasing from 6.59 percent in 1981 to 7.64 percent in 1986 for the top 1 percent of tax units, from 17.31 to 18.77 percent for the top 5 percent, and from 35.11 to 36.56 percent for the top 15 percent. In fact, the movement toward inequality must have been even greater than the tax data show because they do not include the large amounts of income taxpayers were able to shelter before the enactment of the Tax Reform Act of 1986.

Many economists and statisticians have examined these trends, but nobody has been able to explain them fully. The declining share of incomes by the lower income classes has been attributed to the increase in the number of single-parent families, slow growth in earnings of production workers, and the disappearance of middle-income jobs among other factors. But none of these explain the recent explosion of earned and property incomes of those in the top tail of the distribution.

The trend toward greater inequality has developed despite the existence of an income tax in the United States for 76 years and of an estate tax for 80 years. Clearly, the tax system never reduced inequality very much, and other forces in the 1980s have swamped whatever equalizing effect it may have had earlier.

Distribution of Tax Burdens

The burdens imposed by the tax system are also unequally distributed. I have been estimating federal, state, and local tax burdens by income classes for the last two decades, using the Brookings MERGE files, which are based on the CPS surveys, modified at the top by the incomes reported on federal individual income tax returns. The tax burdens of the bottom 90 percent of the income distribution did not change very much from 1966 to 1985 (see table 2, page 10). By contrast, the tax burdens of the top 10 percent of income recipients fell markedly. The drop was especially dramatic for the very richest. Effective tax rates of the top 5 percent fell by one-fifth; of the top 1 percent by more than a third.

Tax burdens of the highest income recipients fell because top federal individual tax rates were reduced throughout this period, from 70 percent in 1966 to 50 percent in 1985. Furthermore, the federal corporate income tax dwindled to relative obscurity; revenues fell from 4.1 percent of gross national product in 1966 to 1.6 percent in 1985. The proliferation of tax-exempt bonds, tax shelters, and personal deductions for such items as state and local taxes, interest payments, and individual retirement accounts (IRAs) also worked to reduce the tax burdens in the top part of the income distribution. The reduction in the corporate tax reflected primarily the investment incentives introduced in the 1960s and liberalized in the 1970s and 1980s, as well as a reduction in profitability.

The distribution of tax burdens has changed since 1985, largely because of the 1986 tax reform. This act increased the progressivity of the tax system, most notably by raising the personal exemptions, standard deductions, and the earned income credit and by shifting about \$25 billion of tax annually from individuals to corporations. However, these changes restored only a small fraction of the progressivity lost in the preceding two decades. For those at the very top of the income distribution, the 1986 law restored about half the reduction in effective tax rates between 1980 and 1985, but left them far below the 1966 levels: the top 1 percent paid only 26.8 percent in taxes in 1988, compared with 39.6 percent in 1966 (see table 2, page 10).

The inescapable conclusion is that the well-to-do in our society have had very large reductions in tax rates in recent years, while the tax rates at the low and middle income levels have not changed much. Since the before-tax distribution has become much more unequal in the 1980s, it follows that inequality has increased even more on an after-tax basis.

Transfer Payments

The other major element of government policy affecting the distribution of income is the system of transfer payments, or negative taxes. This system includes pub-

lic assistance programs designed explicitly to help the poor, as well as programs, such as retirement and unemployment benefits and health insurance, to serve other purposes. To evaluate the impact of the tax-transfer system on the distribution of income, cash and in-kind transfers must be added to market incomes while taxes are deducted.

While I cannot separate the effects of transfer payments and taxes on the recent changes in the after-tax income distribution, a snapshot for a recent year — 1985 — suggests what happened. When family units are arrayed by their incomes from market production (wages, salaries, interest, dividends, etc.), the U.S. tax system is only mildly progressive. On the other hand, transfer payments are highly progressive. Taxes in 1985 were regressive in the two lowest deciles and proportional thereafter, while transfer payments declined from more than 200 percent of market incomes in the lowest decile to 1.4 percent in the highest. On balance, families in the lowest three deciles received more in transfers than they paid in taxes, while those in the top seven deciles paid more in taxes than they received in transfers.

Clearly, the tax-transfer system is progressive, primarily because of transfers, not taxes. What we are doing is financing redistributive transfers with taxes that are roughly proportional to incomes. Moreover, the tax system has been getting less progressive in the last two decades, while the ratio of transfers to income has been increasing. In other words, the recent increases in transfer payments in the United States have been financed by the low- and middle-income groups, while the rich have been getting tax cuts.

Answering the Income Tax Critics

Most people support tax progressivity on the ground that taxes should be levied in accordance with ability to pay, which is assumed to rise more than proportionately with income. Economists have long had trouble with the “ability to pay” concept. In recent years they have revived the old notion that consumption measures ability to pay better than income does. I believe that the person in the street is right and that we should continue to rely on the income tax to raise revenue in an equitable manner.

Ability to Pay

In the latter half of the 19th century, progressive income taxation was justified by “sacrifice” theories that emerged from discussions of ability to pay. Under this doctrine, ability to pay is assumed to rise as incomes rise, and the objective is to impose taxes on a basis that would involve “equal sacrifice” in some sense. If the marginal utility of income declines more rapidly than income increases and the relation between income and utility is the same for all taxpayers, equal sacrifice

leads to progression. Whether or not one believes in sacrifice theory, the concept of ability to pay has been a powerful force in history and has undoubtedly contributed to the widespread acceptance of progressive taxation.

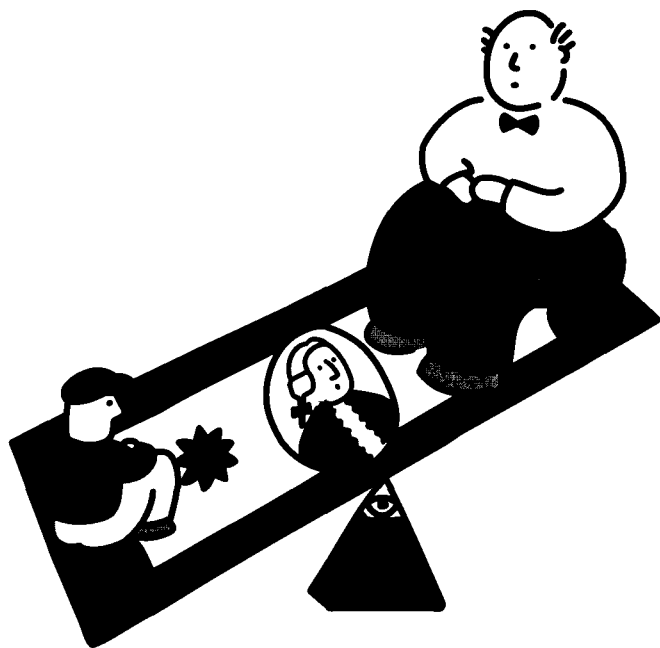
In my view, the income tax should be used to reduce the great disparities of welfare, opportunity, and economic power arising from the unequal distribution of income. I recognize that this view is not widely held and has probably not been the major rationale for income tax legislation in the United States or in most other countries. The income tax is widely used primarily because it raises large amounts of revenue in a moderately progressive way. Recent income tax reforms have concentrated mainly on eliminating tax preferences to improve horizontal equity; income tax rates that had been pushed to very high levels are being moderated. The world appears to be moving toward a consensus that the income tax should be levied on a broad base with graduated rates reaching a maximum of 50 percent or less.

Economic Incentives

The effects of the progressive income tax on incentives to work and to save are hard to measure. As is well known, the substitution and income effects of taxation work against each other, and the net result cannot be predicted.

Sample surveys have revealed that professional personnel do not vary their hours of work in response to high tax rates. However, recent econometric studies suggest that the pre-1986 income and payroll taxes reduced the work effort of primary earners in the United States by about 8 percent, while secondary earners — who have a greater opportunity to vary their labor input — reduced their work effort by as much as 30 percent. According to these studies, the 1986 reform may have increased labor supply of married men by only 1 percent and of married women by less than 3 percent, largely because the marginal tax rates of most workers were not reduced very much. My Brookings colleague Gary Burtless estimates that the Reagan tax and transfer policies increased average annual hours of men aged 25–54 by no more than 2–4 percent and of women in the same age group by no more than 3.5 percent.

Historical trends in U.S. labor supply are not consistent with the finding that taxes have reduced work effort. Adult males have been reducing their labor supply over the last 40 years, but this reduction reflects the trend toward earlier retirement, little of which is the effect of tax rates. The labor force participation of women has risen sharply in recent years, despite high marginal rates resulting from the requirement that married couples must file joint returns to benefit from income splitting. Studies in other countries are not reliable enough to support conclusions about the relationship between taxes and labor supply.



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The effect of taxes on saving is even more ambiguous. A few studies claim that they have found a significant response to an increase in the real after-tax return on saving; others find that the response, if any, is close to zero. The falloff in the personal saving rate in the United States in the 1980s confounded most economists in view of the reductions in the marginal tax rates, the incentive provided by IRAs, and the high real interest rates, all of which should have increased the incentive to save.

The strongest conclusion one can draw from the available evidence is that the incentive effects of taxation have been relatively small. Yet the supply-siders were convinced that the incentive effects are large enough to increase revenues when tax rates are reduced. U.S. tax rates were cut sharply in 1981 and 1986, but these cuts had little effect on labor supply and no effect on saving. Under the circumstances, so long as tax rates are not pushed to punitive levels, incentive considerations do not justify neglect of the distributional objective of tax policy.

Income vs. Expenditure Tax

The revival of interest in the expenditure tax can be traced to the difficulties of taxing income from capital under the income tax. However, economists and tax lawyers have also found efficiency reasons to prefer the expenditure tax, and these need to be addressed.

A basic difference between the income and expenditure taxes is in the time perspective of the two taxes. The perspective of the income tax is relatively short run — a year or several years to allow for short-run income fluctuations. Consumption is more stable than income and is alleged, therefore, to be a better measure of long-term well-being. In fact, under certain simplifying assumptions, the *bases* of taxes on the discounted present value of income and expenditure are the same over a lifetime. Assuming perfect capital markets, constant discount rates that apply equally to all people under all circumstances, tax rates that are constant and proportional, and no gifts and bequests, the present values of lifetime expenditures of people with the same (discounted) lifetime incomes are the same regardless of when the incomes are consumed.

Advocates of the expenditure tax regard the lifetime perspective as a major advantage because it permits them to pretend that taxing consumption is equivalent to taxing personal endowments. A tax on endowments, if they could be measured, would avoid the distortionary effects of either an income tax or an expenditure tax. If it is assumed that lifetime consumption approximates endowment, then taxing consumption at flat and constant rates treats equally all taxpayers with the same endowment. This logic seems to lie behind the strong support of the expenditure tax by many economists, even though the unrealistic assumptions involved in this line of reasoning strain credulity.

The lifetime perspective has little merit even without the endowment rationale. In my view, it is difficult enough to measure economic circumstances over relatively short periods. Taxation of lifetime consumption (or income) hardly seems appropriate in a world of changing tax rates, substantial family instability, economic and political change, and uncertainty. Except for the attractiveness of the arithmetic, lifetime economic circumstances as measured by discounted lifetime incomes or consumption cannot be regarded as satisfac-

tory indexes of ability to pay. Moreover, taxation of annual consumption expenditures at graduated rates would destroy the identity of lifetime taxes of taxpayers with the same (discounted) lifetime incomes.

The expenditure tax is alleged to be superior to the income tax on the additional ground that the income tax reduces the return on saving and therefore encourages current rather than future consumption. Even if saving remained unchanged, the distortion generates a welfare loss for consumers. It has been pointed out by many economists that this effect must be balanced against the welfare cost of further distorting the choice between labor and leisure. There is no theoretical basis for judging whether the welfare gain from eliminating the intertemporal distortion of consumption would exceed the welfare loss from increasing the intratemporal distortion of the labor-leisure choice.

A tax that omits saving from the tax base can be shown to be the same as a tax applying only to labor income and exempting all property income. Several expenditure tax advocates have, in fact, proposed a tax on labor income on grounds of simplicity and administrative feasibility. Most people would be appalled by a proposal to substitute a wage tax for income tax, yet that is essentially what expenditure tax proponents are advocating.

Many economists are attracted to the expenditure tax because it would not tax income from capital and would thus eliminate all the income tax problems arising from the use of the realization principle for calculating capital gains and losses and the accounting conventions for inventories, depreciation, and depletion in arriving at net business profits. There would also be no need to adjust the tax base for inflation as consumption would be measured appropriately in current dollars. These are serious problems for income taxation and I shall deal with them later, but it would be unfortunate to abandon the income tax for administrative and compliance reasons alone.

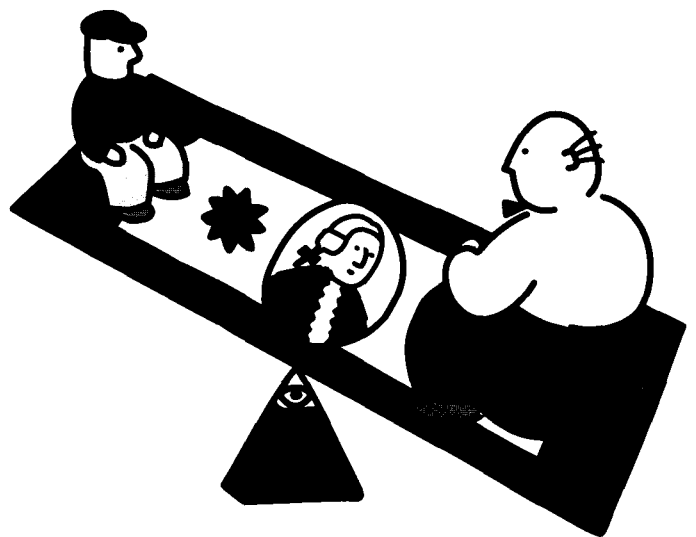
The transition from the income tax to an expenditure tax would be troublesome. The retired elderly would draw down assets, some of which had been previously taxed under the income tax, to finance current consumption that would be taxed yet again. To avoid this double tax, some method would need to be devised to identify consumption from previously taxed accumulations. Grandfathering all assets at the time an expenditure tax is initiated would leave a big loophole for people with large amounts of untaxed accrued capital gains. But I have not seen any practical method of making the distinctions necessary to prevent wholesale tax avoidance and to achieve equity.

Under an expenditure tax, those taxpayers who save could accumulate large amounts of wealth over a lifetime. Many, but by no means all, expenditure tax advocates support wealth or estate and gift taxes to prevent excessive concentrations of wealth. But the history of transfer taxation here and abroad provides little assur-

ance that effective death and gift taxes would be levied to supplement an expenditure tax.

Proponents of expenditure taxation often compare the merits of a comprehensive expenditure tax with the income tax as it has developed. It is hard to believe that an expenditure tax would be enacted without numerous exemptions and exclusions. In fact, most of the eroding features of the income tax (for example, the preferences for housing, fringe benefits, child care, and state and local borrowing) might be carried over to the

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expenditure tax. Thus, an expenditure tax is no less immune to erosion than the income tax, and in such circumstances, it loses much of its attractiveness.

I conclude that income is a better indicator of ability to pay than consumption and that the major upheaval of substituting an expenditure tax for an income tax cannot be justified on theoretical or practical grounds.

How Much Progression?

The effective degree of progression of the income tax depends on the comprehensiveness of the tax base as well as on the tax rates. We have learned from experience that high, graduated tax rates do not ensure progressivity of the income tax. For most of the postwar period, the top U.S. income tax rates were 70 percent or higher. Yet little equalization resulted because of the erosion of the base of the individual and corporate income taxes and because of increases in the payroll tax for Social Security.

Two major pieces of tax legislation were enacted during the 1980s. One increased inequality, the other reduced it. The 1981 act, enacted after Ronald Reagan's sweeping victory in the 1980 presidential election, increased inequality by reducing income tax rates by 23 percent across the board (with a top rate on ordinary income of 50 percent), lowering the capital gains rate to a maximum of 20 percent, introducing generous deductions for individual retirement accounts, and providing very liberal depreciation allowances for business investment on top of the previously enacted investment tax credit. The Tax Reform Act of 1986 reduced inequality by increasing personal exemptions and the standard deduction, equalizing the tax rates on capital gains and ordinary income, and closing numerous loopholes. At the same time, income tax rates were reduced to a maximum of 33 percent on individuals and 34 percent on corporations.

Despite the large rate cuts at the top of the income scale, the 1986 act increased income tax progression, though not to the 1980 level. Nonetheless, it was the first movement toward greater progressivity since at least 1964, when the Kennedy-Johnson tax cut was enacted.

I suggest that a minimal goal of federal tax policy in the next several years should be to restore the equalization achieved by the federal tax system in the mid-1970s. While this may appear to be a modest goal, it turns out to be a rather ambitious undertaking, particularly if income tax rates are to be kept to moderate levels. Before calculating the tax rates, it is necessary first to establish the appropriate tax base for a modern income tax.

The 1986 Tax Reform

The proper base for the income tax was described 50 years ago by Henry Simons, the influential economist who argued that it should conform with an economic

definition of income. According to Simons and others, income is the sum of an individual's consumption and change in net worth during a particular time period. For a long time, the federal income tax base was a far cry from a comprehensive definition of income. In 1986, however, Congress reversed its previous practice and enacted a wholesale tax reform that moved the income tax a long way toward the Simons ideal. This remarkable piece of legislation can provide the basis for achieving the distributive objectives discussed earlier with moderate tax rates.

The Tax Reform Act of 1986, a major step toward comprehensive income taxation, greatly improved the fairness and efficiency of the tax system. By doubling personal exemptions and increasing the standard deduction, the act relieved about 5 million poor people from paying any income tax. This step restored the principle (abandoned by Congress in 1978) that people officially designated as "poor" should not be required to pay income tax. The principle was perpetuated by the resumption in 1989 of an automatic annual adjustment of the exemptions and standard deduction for inflation.

Significant increases were made in the earned income credit for wage earners with families. These increases eliminated almost the entire Social Security payroll tax (including the employer's share) for those eligible for the full credit and reduced the tax burden for many low-income workers.

For the first time since 1921 realized capital gains were made taxable as ordinary income. This change is the keystone of comprehensive tax reform: it reduces the incentive to convert ordinary income into capital gains and removes one of the major elements of tax shelter arrangements. Moreover, this change made it possible to reduce tax rates without reducing the progressivity of the income tax.

A good start was made to reverse the erosion of the individual income tax base. For example, unemployment benefits, which were previously taxable only if a married taxpayer's income exceeded \$18,000 (\$12,000 for a single taxpayer), were made taxable regardless of the size of income. Deductions for state and local sales taxes were eliminated and those for consumer interest were phased out. For administrative reasons, deductions for unreimbursed business expenses, costs incurred in earning investment income, and other miscellaneous expenses were allowed only to the extent that they exceed 2 percent of income.

Some of the most egregious loopholes and special tax benefits were eliminated. Many tax shelters were rendered unprofitable by denying deductions for losses from passive activity against income from anything but passive activities. Tax subsidies for borrowing (except for mortgages) were eliminated by limiting the deduction for interest expenses to the amount of investment income reported on the individual's tax return. Deductions for contributions to IRAs were cur-

tailed, while deductions for business expenses such as meals, travel, and entertainment were limited to 80 percent of outlays. Tax preferences benefiting defense contractors, banks, oil companies, and other industries were narrowed. On top of all these changes, the minimum tax for both individuals and business was retained and strengthened.

Finally, the individual and corporate tax rates were cut drastically. Under the individual income tax, two rates — 15 and 28 percent — were substituted for the earlier 14 rates, which rose to a maximum of 50 percent. However, the benefits of the lowest rates and of the personal exemptions were phased out for higher income taxpayers at a 5 percent rate. As a result, the new individual income tax rate structure has four brackets, with rates of 15, 28, 33, and 28 percent. The general corporate rate was cut from 46 percent to 34 percent. Despite these large rate cuts, the act was expected to be roughly revenue neutral in total over the first five years, but to shift roughly \$25 billion of tax annually from individuals to corporations.

The distributive effect of the 1986 act is distinctly progressive, especially if the increase in corporate tax liabilities is taken into account. I have calculated the change in average effective tax rates of the nation's families on the basis of the distribution of income estimated from the Brookings MERGE file. Total federal tax burdens decline in the lower nine deciles and rise in the top decile. In the lower deciles, the tax reductions result from increases in the personal exemptions, standard deduction, and the earned income credit under the individual income tax. The increases at the top reflect the broadened individual income tax base, as well as the increase in corporate tax liabilities, which is assumed to fall on owners of capital in these calculations. However, as already noted, this increase in progressivity only partially reversed the reductions that had taken place in the 1970s and early 1980s.

The Unfinished Agenda

Despite the progress made in 1986, the federal income tax in the United States falls considerably short of the comprehensive income target. I assume that we shall continue to tax capital gains on a realization, rather than an accrual, basis, and that gifts and bequests will be taxed under a separate transfer tax. Nevertheless, a great deal more could be done to broaden the tax base for equity, efficiency, and revenue reasons.

Personal exemptions, standard deductions, and rate bracket limits are adjusted annually for inflation, but the tax base is not. Of the two types of adjustment, adjustment of the tax base is by far the more important. Perhaps the major reason why the income tax tends to be in disrepute is the discrimination against capital income inherent in a nominal income tax. An inflation adjustment of asset prices should be incorporated in the tax law to compute real capital gains and losses,

real interest and expenses, and real inventory and depreciation allowances. The adjustment of interest is admittedly difficult, but the widespread use of computers should ease the administrative and compliance problems.

Restoration of a tax differential between capital gains and ordinary income should be resisted at all costs. Equalization of the tax rates eliminates the incentive to convert other income into capital gains, simplifies business and financial decisions, and simplifies the income tax. Aside from the correction for inflation, the one additional reform needed in the capital gains tax is to include in the tax base unrealized capital gains transferred by gift or at death. Taxing such gains would reduce the lock-in effect of the tax on transfers of assets and eliminate a source of horizontal inequity.

A major neglected problem in most countries is the erosion of the tax base from the exclusion of employee fringe benefits. Trade unions, as well as employers, staunchly defend the continued exclusion of fringe benefit income, but in fact the largest subsidies go to the highest paid employees. Loopholes for union members and other workers are no more defensible than those for the rich. Taxation of fringe benefits would encourage their conversion into cash compensation, thus giving employees more control over the disposition of their income and the choice of the providers of their services. Australia and New Zealand have shown the way to reform in this area by taxing fringe benefits (other than contributions to pension plans) at the corporate tax rate. This method of handling a difficult, but urgent, problem is simple and effective.

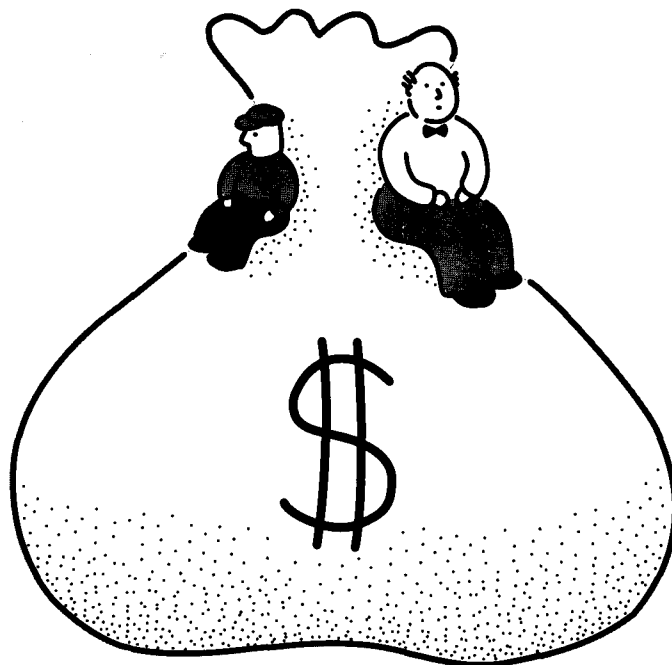
Social Security benefits continue to receive favorable treatment, even though the elderly can no longer be regarded as a disadvantaged group. Under current law, the medical insurance subsidies are not subject to tax, and less than half of retirement and disability benefits is taxable to married couples with income above \$32,000 (\$25,000 if single). The value of the medical insurance subsidies should be subject to tax in full, and retirement and disability benefits should be treated like private pensions without any income thresholds, which would mean that roughly 85 percent of the benefits would be taxable.

The treatment of owner-occupied housing remains unsatisfactory. The exclusion of imputed rent from the tax base and the deduction of mortgage interest by most homeowners are probably sacrosanct, but it is possible to discourage borrowing without promoting rearrangements of debt for tax purposes. The solution is to broaden the limitation on deductions of investment interest to include all interest payments. That is, a deduction for all interest payments would be allowed but limited to the amount of reported investment income. To accommodate the home-owner lobby, the limit could be raised to net investment plus an arbitrary amount, say, \$10,000 — enough to take care of the vast majority of home owners. The broader interest limita-

Table 3. Broadening the Tax Base

*Adjusted gross and taxable income under the Tax Reform Act of 1986 and under a comprehensive income tax, 1990
(In billions of dollars)*

Item	Adjusted Gross Income	Taxable Income
Tax Reform Act of 1986	\$3,545	\$2,407
+		
Personal deductions	0	68
Transfer payments	226	164
Fringe benefits	187	185
Two-earner deduction	-82	-81
Other	43	42
=		
Comprehensive Tax	\$3,919	\$2,785



Notes: Personal deductions allow flat standard deduction of \$4,000; interest deduction limited to investment income plus \$10,000; tax deduction limited to income taxes; 10 percent floor on deductions for medical expenses and casualty losses; 2 percent floors on deductions for charitable contributions and miscellaneous expenses; and no standard deduction for the elderly and the blind. Transfer payments include 85 percent of Social Security retirement and disability benefits for all taxpayers, workers' compensation, and veterans' benefits; and 50 percent of the insurance value of hospital insurance benefits. Fringe benefits include premiums paid by employers for health and life insurance and other fringe benefits; interest on life insurance policies; and IRAs of persons covered by employer pension plans. The two-earner deduction would be set at 20 percent of earnings of the spouse with lower earnings up to a maximum of \$70,000. Other includes unrealized capital gains transferred by gift or at death, interest on newly issued state and local securities, and all preference items now subject to the minimum tax.

Source: Congressional Budget Office.

tion would remove the discrimination against borrowing for other purposes and the incentive to substitute home equity loans for other types of borrowing.

Other deductions are still too generous. The Simons definition of income includes all sources of income, without any deductions for the uses of that income. For equity reasons, it is appropriate to permit deductions for such unusual expenses as medical payments and casualty losses. I would retain the deduction for state income taxes to moderate interstate tax differentials. However, the property tax is largely a benefit tax and therefore should not be deductible. Nor is it necessary to allow a deduction for the first dollar of charitable contributions on incentive grounds. Little or no charitable giving would be lost, and much revenue would be gained or reductions in tax rates would be possible if the federal deduction for property taxes were disallowed and the deduction for charitable contributions were restricted to amounts in excess of 2 percent of income. The tax exemption for interest on newly issued state and local bonds should also be removed.

Although income tax compliance is better in the

United States than in most other countries, roughly 15 percent of individual income is still unreported, according to IRS estimates. Extension of withholding to interest and dividends would improve compliance. Congress enacted a withholding system for these income items in 1982, but repealed it the following year under pressure from the financial institutions. Since information returns are required for annual interest and dividend payments of \$10 or more, the marginal costs of complying with a withholding system would be small.

One of the major features of the 1986 tax law was to telescope the schedule of tax rates into two acknowledged and two concealed brackets, a bizarre four-bracket rate structure of 15, 28, 33, and 28 percent. The reduction in the number of brackets was a response to the flat tax proposals that were being promoted when the tax reform bill began its journey through Congress, while the unsightly bulge in the rate schedule was motivated by revenue considerations. It is not necessary to return to 14 brackets, but there is room for more rate graduation without the bulge.

In this connection, consideration needs to be given

to improving the structure of estate and gift taxes to compensate for their low average rates. These taxes were almost gutted by increases in the exemptions and reductions in the tax rates in 1981. Now that the top income tax rates are even lower, it is time to rely more heavily on the estate and gift taxes.

The reduction in the tax rates led to two additional changes in the 1986 act that I believe were unfortunate. Congress eliminated the deduction for two-earner couples and ended the privilege of averaging income for tax purposes. Both provisions should be restored in the interest of horizontal equity.

Finally, contrary to the prevailing view among public finance experts, Congress clearly believes that a separate, unintegrated corporate tax is essential for effective income taxation. A separate tax prevents individuals from avoiding the income tax by accumulating earnings at the corporate level, although some might question whether corporations should be taxed at a higher rate than the top bracket individual rate. But in its present form, the corporate tax encourages debt financing. It is alleged to be a major cause of the recent upsurge in leveraged buyouts and mergers. The remedy is twofold. Deductions or credits should not be allowed for dividends received at the individual level. And corporations should not be allowed to deduct interest, but their tax rate should be reduced to the neighborhood of 15 percent to maintain the same level of revenues now produced. In other words, the corporate tax should become a low-rate tax on net corporate income before distributions.

More Progression at Reasonable Rates

The reforms I have suggested would greatly increase the income tax base and permit a realignment of the tax rates to achieve the distributional objectives described earlier. At calendar year 1990 levels, the tax base would increase from \$2.4 trillion to \$2.8 trillion (*see table 3, page 17*). The increase in the base leaves enough room to cut rates in the lowest taxable income brackets and still keep the top tax rates at reasonably modest levels.

In redesigning the rate structure, I suggest scrapping the multiple schedule system that was developed to reduce the tax advantage of married couples relative to single people under income splitting. It is simpler to use one set of rates and to rely on the personal exemptions to take into account differences in ability to pay of families of different size. The restored deduction for two-earner couples (20 percent of the earnings of the spouse with the lower earnings up to \$70,000) would help avoid a significant marriage penalty.

The same revenue and progressivity of present law could be generated by a tax schedule ranging from 7 percent on the first \$5,000 of taxable income to 26 percent on taxable income in excess of \$35,000, without the bulge in tax rates under current law (*see table 4, plan I, page 19*). Thus, a wide margin exists for increasing pro-

gressivity at the top of the income scale, while keeping rates moderate. To restore the progressivity of the federal tax system to its 1977 level, the range of graduation would have to be expanded and the rate of graduation increased. A starting rate of 4 percent on the first \$5,000 of taxable income rising to 48 percent on taxable income above \$250,000 would accomplish this objective (*see table 4, plan II, page 19*).

Another change to increase progressivity would be to increase the earned income credit for low-income families. Today, the credit is the same for all families, regardless of the number of children. The credit would be more effective in combating poverty if it increased with family size. For example, the current 14 percent credit could be maintained for families with one child, and four percentage points, or roughly \$250, could be added for each additional child. With this modification, the earned income credit would increase the likelihood that a family with several children could earn enough to remain outside the welfare system.

Table 5 reports the average effective federal income tax rates by population deciles under both plans (*page 19*). The average effective rates needed to restore overall progressivity to 1977 levels are lower than those under present law in the bottom nine deciles and higher in the top decile. For the top 1 percent of the family units, the average effective rate rises from 21 percent to 30 percent, which cannot be regarded as punitive.

I recognize that few people would go as far as I would in broadening the tax base. But that does not mean that the objective of greater progressivity must be abandoned. Even if there were no additional base-broadening, the same degree of progressivity that prevailed in 1977 could be achieved in 1990 with rates ranging from 7 percent at the bottom to 56 percent at the top.

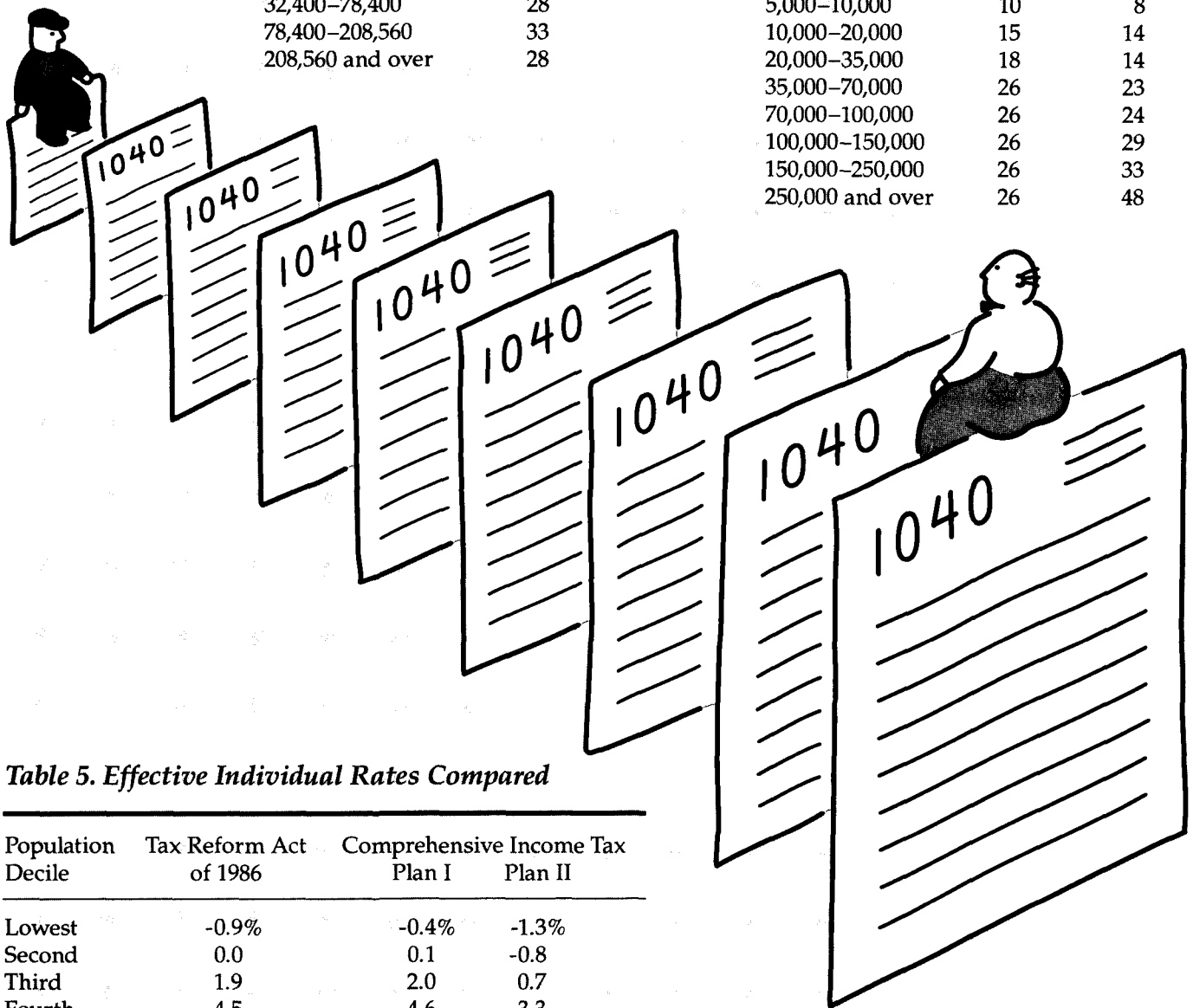
It is clear from this analysis that the revenue potential of the income tax has not been exhausted in this country. Even if the base is not broadened, the income tax can be used to raise considerable additional revenues and eliminate the recurring federal deficits. Each percentage-point increase in the individual and corporate income tax rates would bring in about \$30 billion in 1994, so that three points would come close to balancing the overall budget in that year. A top individual income tax rate of 31 percent and a corporate rate of 37 percent cannot be regarded as punitive or harmful to economic incentives.

What is inappropriate in my view would be the introduction of a value-added tax, as some are suggesting. The value-added tax is regressive and imposes unnecessarily heavy burdens on the lower income classes. With tax rates as low as they are today, more revenues should come from the income tax, the tax paid by those who have the ability to pay. In view of the recent reductions in the progressivity of the federal tax system, it would be unconscionable to enact the distinctly inferior alternative of a value-added tax. □

Table 4. Rates for Greater Progression

Comparison of tax rates under the Tax Reform Act of 1986 and under two comprehensive income taxes, 1990

Tax Reform Act of 1986		Comprehensive Income Tax		
Taxable Income	Rate	Taxable Income	Rate Plan I	Rate Plan II
\$0-32,400	15%	\$0-5,000	7	4
32,400-78,400	28	5,000-10,000	10	8
78,400-208,560	33	10,000-20,000	15	14
208,560 and over	28	20,000-35,000	18	14
		35,000-70,000	26	23
		70,000-100,000	26	24
		100,000-150,000	26	29
		150,000-250,000	26	33
		250,000 and over	26	48

**Table 5. Effective Individual Rates Compared**

Population Decile	Tax Reform Act of 1986	Comprehensive Income Tax Plan I	Comprehensive Income Tax Plan II
Lowest	-0.9%	-0.4%	-1.3%
Second	0.0	0.1	-0.8
Third	1.9	2.0	0.7
Fourth	4.5	4.6	3.3
Fifth	6.2	6.2	5.0
Sixth	7.4	7.4	6.1
Seventh	8.4	8.5	7.0
Eighth	9.4	9.5	7.8
Ninth	11.1	10.9	9.1
Highest	16.5	16.5	18.9
Top 5 percent	18.0	18.1	22.3
Top 1 percent	20.7	20.8	30.5
All deciles	11.1	11.1	11.1

Notes: The table assumes the corporate income is borne by capital income. Population is arrayed by comprehensive income, which includes all transfer payments, the employer share of payroll taxes, and the corporate income tax (allocated to capital income). The first, or lowest, decile excludes families with zero or negative incomes; the data for all deciles include families with zero or negative income.

Modern Pluralism and the First Amendment

The Challenge of Secular Humanism

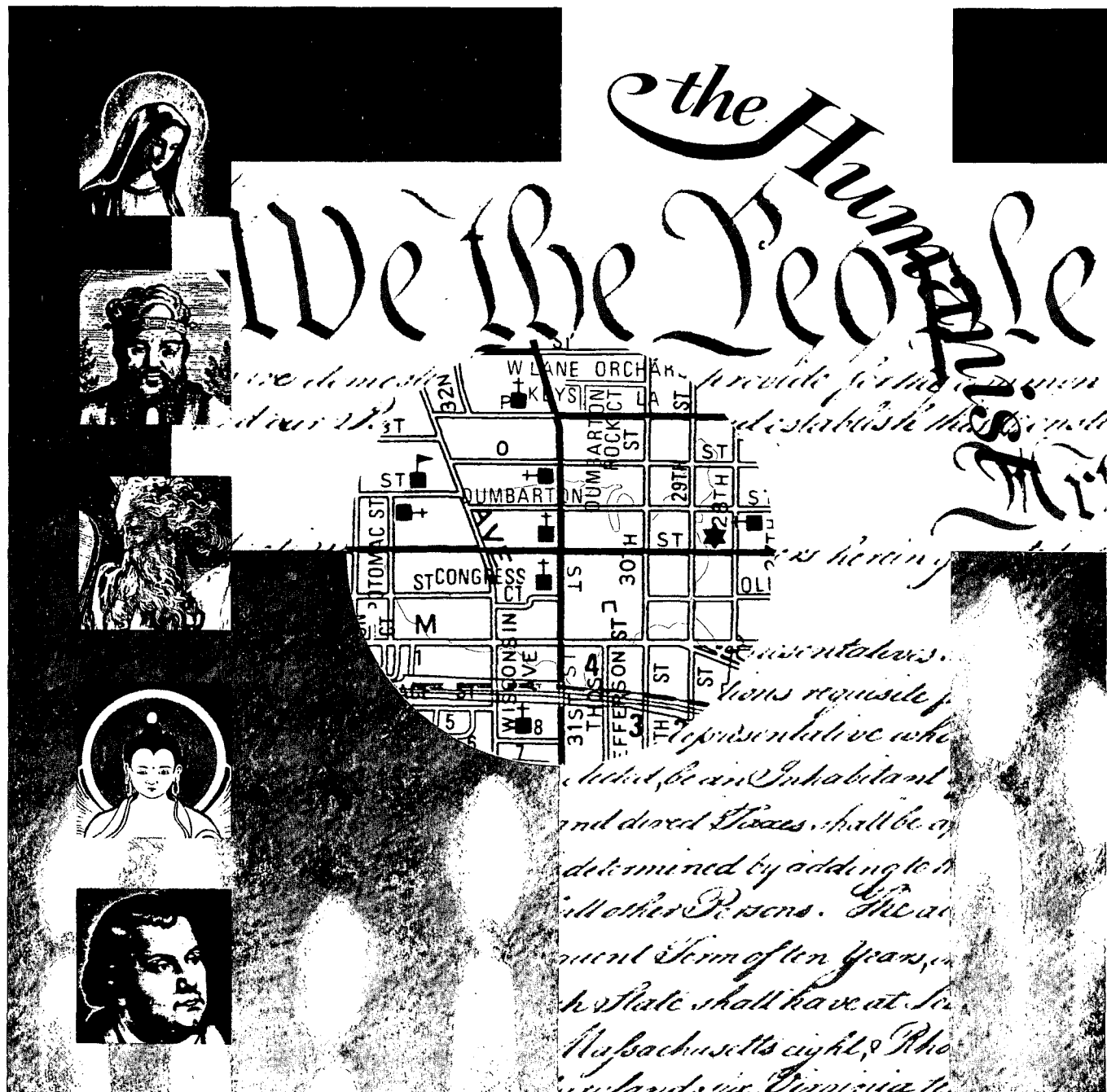
James Davison Hunter

*"Congress shall make no law respecting an establishment of religion,
or prohibiting the free exercise thereof...."*

The moral project of the nation's founders was to construct not only a constitutional order but a public philosophy that would establish broad and equitable standards of public justice, standards that would sustain this new United States far into the future. Surely this high purpose was at the heart of the religious liberty clauses of the First Amendment. The 16 words that make up the two clauses guarantee that as long as the nation exists, the convictions of individual conscience shall exist free of state interference and coercion. So too do they guarantee that the interests of particular faiths will not be extended by the direct or indirect patronage of the state, at least not to the disadvantage of minority faiths.

With the recent expansion of religious and cultural pluralism in America, profound and divisive questions have been raised about whether those guarantees, particularly the latter, are being met. These questions are unlikely to be resolved until a central issue is addressed: Given the expansion of pluralism, and secularism in particular, how is "religion" to be defined and how is that definition to serve the traditional ideal of public justice?

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Principle and Practice

Though the religion clauses were established as general principles of law that could incorporate a broad range of faiths in 18th and early 19th century America, their practical intention could only have been to reduce the deep and long-standing tensions spawned by the various inter-Protestant rivalries: the Congregationalists and Unitarians in Massachusetts, Connecticut, and New Hampshire, for example, against the "swamp of sectarianism" spreading in Pennsylvania and other mid-Atlantic states; or the Methodists, Baptists, and Presbyterians in the southern states against each other and against the power of the Episcopalians.

These rivalries, born of the conviction that each denomination and faction possessed the true legacy of the Reformation while all others were at least partially mistaken, defined the predominant cultural tensions of the time, and therefore the tensions that needed to be resolved most urgently. In this context, the clauses were effective; their moral purpose was largely realized.

In principle, of course, the clauses also provided the mechanism for resolving conflicts outside the world of Reformational Christianity, but at the beginning of the 19th century, that was not at issue. Both in population and character America was indisputably Protestant.

The potency of the clauses to establish an even broader foundation of public justice — one that would

encompass the interests of a growing non-Protestant population — was soon tested. The challenge came with the massive immigration of Catholics from Ireland and Germany between the 1830s and the 1850s, the immigration of German (Ashkenazim) Jews later in the century, and the growth of the new American sect of Mormonism. Even with this expansion of religious and cultural pluralism, the liberties guaranteed by the First Amendment did not extend far beyond the Protestant world. While no one Protestant denomination enjoyed the patronage of the state, the cause of a “pan-Protestantism” had a substantial, if unofficial, government endorsement. The consequence was the restriction of the full religious liberties of other, non-Protestant communities of belief.

The struggle of minority faiths in the 19th century to achieve in practice what the First Amendment had already guaranteed in principle was frequently bitter. Protestant resistance was deep and sometimes violent. This was especially true for the Catholic community, which, because of its remarkable demographic growth, provided the first and most credible threat to Protestant domination over public culture. The conflict, of course, was more than theological in nature; the antagonism centered on the competing social, political, and economic interests of each community of faith in what was, in effect, a zero-sum cultural contest. The larger Protestant community sought to maintain, if not extend, its control over the symbolic territory of public life against the intensifying claims of the Catholic, Jewish, and Mormon communities for their own space in the public square. As the chronicle of anti-Catholicism and anti-Semitism unhappily documents, the ideals of the religion clauses had still not been fully realized by the end of the 19th century.

That failure is significant because it provides something of a precedent for today’s developments. Certainly many of the social dynamics taking place now find a parallel in the past. In the last half of the 20th century, the power of the clauses to establish public justice has been challenged again by the further expansion of religious and cultural pluralism in America. About 28 percent of the population is Catholic; Jews make up about 2.5 percent. Mormons now constitute 1.6 percent of the population (roughly 3.8 million people) and are one of the fastest growing religious denominations in America. Much more significant is the expansion of pluralism beyond the traditions of Judeo-Christian faith. There are about as many Muslims in America, for example, as there are Mormons, and more Muslims than Episcopalians. The numbers of Hindus and Buddhists have also grown prodigiously since the end of World War II.

But the fastest growing community of “moral conviction” in America is that which social scientists call “secularists” — those who claim no religious preference at all. Between 1952 and 1962 this group made up only 2 percent of the population; by 1972 it was 5 per-

cent, and by 1982, 8 percent. Today it constitutes approximately 11 percent of the population.

American pluralism has been expanded not only by the growing number of faiths and cultural traditions, but by the splintering of these traditions as well. All of the major religious traditions are now divided into orthodox and progressive camps. Some are divided still further. Certainly the dominant factions in Protestantism, Catholicism, and Judaism are all characterized by an embrace of the secular Enlightenment. The survey evidence makes clear that with some exceptions, these liberal religious traditions share much more in common culturally with each other and with the growing secularist population than they do with orthodox believers in their own religious heritage.

It would be difficult to overemphasize the novelty of contemporary cultural circumstances vis-à-vis those that prevailed in the late 18th century when the Bill of Rights was drafted. As the secularist and liberal religious populations have grown, so too has an awareness of the secularistic nature of contemporary American public culture. Some on the religious right claim that there is a conspiracy afoot, that “secular humanists” and their ideological allies now “control” the major institutions of American life. While no serious scholar would accept that assessment at face value, most recognize the secular character of public life and that a growing constituency prefers it that way. Citing mountains of empirical evidence drawn from the work of Max Weber, Emile Durkheim, Robert Bellah, and others, one could argue quite plausibly that a secularistic humanism has become the dominant moral ideology of American public culture and now plays much the same role as the pan-Protestant ideology played in the 19th century.

If that is the case, the question that inevitably arises is how the law should treat nontheistic faiths and ideologies. Though not religions in the same sense that Protestantism, Catholicism, and Judaism are considered to be, should they nonetheless be considered religions for First Amendment purposes? If they are, how is the legal interpretation of the religious clauses affected?

A Problem of Definitions

The courts themselves have been groping toward answers to these questions for several decades. As with so many other legal matters, this issue has become entangled in technical debate. For First Amendment purposes, should religion be defined by substantive criteria, by the presence of specific attributes, namely a suprahuman force? Or should religion be defined by functional criteria, by what it does for individuals and communities? These two approaches to definition are by no means mutually exclusive, though they carry different analytical consequences. The substantive model generally limits religion to the range of tradi-

tional theisms: Judaism, Christianity, Islam, Hinduism, and so on. The functional model, is more inclusive. By defining religion according to its social function, this model equates religion with such terms as cultural system, belief system, meaning system, moral order, ideology, world view, and cosmology.

For all practical purposes, even those who prefer the functional definition still think of religion in its traditional sense — a body of beliefs and practices. But as its name implies, the functional model focuses on a cultural system and does not require a deity for the system to be considered religious in character. Confucianism and Theravada Buddhism, for example, contain no supernatural reference to speak of, yet few would exclude them from the pantheon of world religions. Others, such as political ideologies, social movements, and therapeutic techniques, are less obvious but still valid examples. Scholars often refer to these as quasi-religions, religion-surrogates, or functional equivalents of religion.

Both methods for defining religion are rooted in venerable intellectual traditions in the social sciences. So it is hardly surprising that there is ambivalence over which approach to adopt for legal purposes. A review of how religion has been defined in American jurisprudence will help frame the modern dilemma.

The Supreme Court first referred to the nature of religion and the First Amendment in the 1870s, when the Protestant consensus was still strong. From then until well into the 20th century the courts defined religion in strictly substantive terms — terms that implied theistic notions of divinity, morality, and worship, as constitutional lawyer Laurence Tribe has written. In 1890, for example, the justices held that the “term ‘religion’ has reference to one’s view of his relations to his Creator, and to the obligations they impose for reverence of his being and character, and of obedience to his will.”

The reason for adopting this restricted approach was simple. As Justice David Brewer wrote for the majority in *Church of the Holy Trinity v. United States* (1892), “. . . our civilization and our institutions are emphatically Christian. . . . From the discovery of this continent to the present hour, there is a single voice making this affirmation . . . that this is a Christian nation.” Thus it was entirely understandable that in the cases finding that the First Amendment did not protect the Mormon practice of polygamy, the Court would legitimate its decision by referring to “the general consent of the Christian world in modern times.”

Fifty years later the challenge of modern conditions found courts beginning to expand their definition of religion by referring to its function. Significantly, these cases turned on the free exercise clause. The first ex-

pansion, in 1943, involved a conscientious objector, Mathias Kauten, who sought exemption from military service because such service would violate of his “religious conscience.” Kauten challenged earlier Supreme Court rulings implying that any religion is inherently theistic when he openly admitted that his objection was not rooted in a “belief in a deity.”

In a decision later upheld by the Supreme Court, a federal court of appeals ruled in Kauten’s favor, in part through a broadened definition of religion. In the words of Federal Judge Augustus Hand: “Religious belief arises from a sense of the inadequacy of reason as a means of relating the individual to his fellow men and to his universe — a sense common to men in the

most primitive and the most highly civilized societies. . . . It is a belief finding expression in a conscience which categorically requires the believer to disregard elementary self-interest and to accept martyrdom in preference to transgressing its tenets. . . . Conscientious objection may justly be regarded as a response of the individual to an inward mentor, call it conscience or God, that is for many persons at the present time *the equivalent of what has always been thought a religious impulse*” (emphasis added).

That decision altered the central reference point in the legal understanding of religion; the fulcrum was no longer the nature of belief in a divine being, but the psychological function of belief. The Supreme Court affirmed this position a year later in the case of *United States v. Ballard*, when it held that courts could not consider the truth of particular creeds or tenets, only the sincerity with which individuals adhered to their creed.

The shift toward a functional definition of religion was completed with two decisions, the Supreme Court handed down in the early 1960s. In 1961 it struck down an old Maryland statute requiring all public employees to declare their belief in God. *Torcaso v. Watkins* involved a citizen seeking to become a notary public who was unwilling to make the declaration because it violated his freedom of belief. The Court agreed, stating that the Maryland law also violated the establishment clause of the First Amendment because it put “. . . the power and authority of the State of Maryland . . . on the side of one particular sort of believers — those who are willing to say they believe ‘in the existence of God.’” It further maintained that “neither a state nor the federal government can constitutionally . . . aid all religions as against nonbelievers, and neither can aid those religions based on a belief in the existence of God as against those religions founded on different beliefs.” In the latter category, the Court specifically mentioned the Eastern religious faiths of Buddhism and Taoism and the functional equivalents, Secular

For First Amendment purposes, should religion be defined by substantive or functional criteria?

Humanism and Ethical Culture.

Then, in 1965, in another case involving conscientious objectors, the Court concluded that religion could be defined to include all sincere beliefs "based upon a power or being, or upon a faith, to which all else is subordinate or upon which all else is ultimately dependent."

A Question of Interests

Up to this point, a functional definition of religion had been almost exclusively sought by and applied to adherents of nontheistic religions claiming their rights under the free exercise clause. The court's recognition of a broader definition of religion represented a significant achievement for humanist organizations and intellectuals who had worked for nearly three decades to have humanism recognized as a religion or at least as a functional equivalent.

But if the courts apply a functional definition of religion in free exercise cases, the question then arises whether the same definition should be applied in establishment cases. This is the critical question underlying the modern debates about secular humanism and the First Amendment, because the interests in establishment cases are precisely opposite to those in free exercise cases.

A functional definition of religion in an establishment case would include humanism as a religion and would thus serve the interests of the religiously orthodox, evangelicals in particular, because it would ensure that the state could not favor secularist values and ideals over transcendent values and ideals. Conversely, a substantive definition of religion would serve secular interests because secular humanism and similar ideologies would fall within the scope of the establishment clause and could therefore be supported by the state without violating the First Amendment.

The significance and subtleties of this issue are still not fully appreciated. Despite the Supreme Court's recognition of nontheistic faiths as religions under the free exercise clause, the argument that secular humanism is a religion remains implausible for most intellectuals. Nonetheless, the question still remains: Are naturalistic beliefs such as secular humanism "religious" in any sociologically meaningful sense? If so, how is one to make sense of them in light of the requirements of the establishment clause?

Secular Humanism as Religion

Within the logic of the social sciences, the status of secular humanism can be explored at two levels. As a formal movement, it serves as a meaning system or cos-

mology designed to provide individuals not only with a clear, alternative means of making sense of their everyday lives, but also with a mechanism for legitimating the larger social order. To its adherents, it is a functional equivalent of religion.

Seen this way, secular humanism is one part of the wider movement of humanism that is institutionalized in such organizations as the American Humanist Association (AHA), the Council for Democratic and Secular Humanism, the Unitarian Universalist Association, the Fellowship of Religious Humanists, and the Ethical Culture Society. The "creeds" of the wider movement, which include statements about the nature of the universe, the nature and origin of knowledge and values, and the origins and goals of human life, are set out in such documents as the Humanist Manifesto I (1933), the Humanist Manifesto II (1973), and A Secular Humanist Declaration (1980), among many others. And its interests are articulated in *Free Inquiry*, *The Humanist*, and *Progressive World*, among other periodicals.

It is important to stress that the original strand of this movement regards itself as an avowedly religious humanism. Its religious dimensions include humanist "churches," known publicly as churches and exempted as religious organizations from the requirement to pay taxes. These churches have credentialed "ministers" — in the Ethical Culture Society, they are called leaders; in the AHA, which was founded mainly by religious humanists, they are called humanist counselors and act as their "ordained ministry," enjoying, in fact, the legal status of ordained pastors, priests, and rabbis. These churches have Sunday services (in the Ethical Culture Society, these are called platform meetings), Sunday schools, and rituals, including weddings, naming ceremonies, memorial services, and the like.

Such groups make up a large part of the network of organizations at the heart of the popular humanist movement in America. Using sociological criteria, then, it is not difficult to make the argument that as an organized movement, humanism, and within it, secular humanism, can be seen as a religion or quasi-religion. It is certainly no less religious than, say, Transcendental Meditation, EST, Psychosynthesis, Arica Training, Scientology, or any of the other organizations of the human potential movement. Nor is it perhaps any less religious than ethical Confucianism or the "high road" tradition of Buddhism.

To make this argument is to invite further speculation about the type of religion humanism might be. At this level it could be understood as both a predecessor and a variant of the larger and more diverse human potential movement. Humanism became es-

*In sum, humanism
as described here
clearly does fit
certain sociological
criteria of religion.*

tablished organizationally decades before the proliferation of religious and quasi-religious experimentation of the mid- to late 1970s, but it has evolved into one organization among many human potential groups. Although movement humanism is primarily ethical and philosophical in concern, whereas most of the human potential groups are primarily therapeutic in orientation, it is part of the same cultural heritage. This ideological compatibility is obvious when humanists speak of the need for "self-actualization," the need for humans to "experience their full potentialities," "to realize their own creative talents and desires," "to fulfill [their] unique capabilities," or when they speak of the "ultimate goal" of humanity as "the fulfillment of the potential growth in each human personality." Humanism and the human potential movement thus share a common linguistic foundation. They also share a common ideological concern with the primacy of subjective experience. The movements are not only closely related, they are complementary.

In sum, humanism as described here clearly does fit certain sociological criteria of religion, and most social scientists would regard it theoretically and empirically as a religion or quasi-religion. It would be more difficult to use the term religion to describe humanism if humanists themselves rejected it, but the majority do not. Ethical Culture, for example, officially describes itself as a "religious fellowship" as does the Fellowship of Religious Humanists. Indeed, the preamble of the American Humanist Association states that the AHA is a "religious organization." Leaders in the popular movement have, at key stages, identified humanism as a religion. (And might still be doing so were it not for fundamentalist attacks on humanism as a religion, which have had the ironic effect of strengthening the secularism in humanism.)

Secular Humanism as Cultural Ethos

To concede that humanism comprises a religious or quasi-religious faith at this formal level is to concede very little. The obvious and more important question is, what does a "religion" for a sometimes eminent, though marginal, and largely politically powerless minority have to do with secular humanism in the larger culture? Few people would suggest that the followers, or even leaders, of humanism have much direct influence on many American institutions, particularly the public schools. Yet it would be equally facile to maintain that the formal ideology of the popular movement has no relation to developments in the larger culture — or that the relationship has not had an effect on public education. What, then, is the nature of that relationship?

To the extent that secular humanism exists in the larger culture, it is not present as a formal ideological system or as a religion. As portrayed in the media or as taught in the public schools, secular humanism lacks

the self-consciousness and articulation of a formal ideology. In any case, at this level it is clearly not a religion. Nevertheless, it is possible to speak of secular humanism as a latent moral ideology, a "folk" ideology, or even a tacit faith. It is in this latent sense that the American social theorist Talcott Parsons spoke of secular humanism as America's fourth faith. In the same sense Leo Pfeffer, a constitutional scholar and the father of separationist doctrine, described humanism as "a religion along with the three major theistic faiths" (a position on which he has since changed his mind because of fundamentalist opposition).

From what does this latent moral ideology derive? Surely one source is the intellectual legacy of the Enlightenment, an ideological revolution that led to the debunking of medieval and reformational cosmologies and the undermining of feudal forms of political authority and theistic forms of moral authority. Enshrined in their place were the commitments to scientific rationality and utopian visions of human progress and perfectibility, commitments that were embedded within the assumptions of philosophical naturalism.

The Enlightenment, which was always less secular in America than in Europe, was not just a solitary event generated by French, English, and German intellectuals in the 18th century. These intellectual commitments have been carried down to succeeding generations and institutionalized within certain sectors of post-Enlightenment society. The main carriers have been members of the intellectual classes, those such as educators, journalists, and lawyers, who derive their livelihood from knowledge. This sector of the population is distinguished by its access to higher education and thus to the institutions of intellectual rationality. Its members are also distinguished, as public opinion surveys indicate, by a general indifference toward traditional theistic beliefs and practices, if not by an outright secularity and a social and political liberalism (at least compared with the general population). This point is vital because it is here also that the popular humanist movement can be located sociologically. Its advocates may occupy only a tiny fraction of the intellectual classes, but their ideology represents a crystallization of the more diffuse ideological themes.

Yet the latent moral ideology of humanism also derives from broader developments within modern life. Two themes occur in the voluminous literature that evaluates change in American culture. The first concerns the increasing "rationalization" of the major institutional bureaucracies of contemporary society. It basically entails the impulse toward what Max Weber and his students have called "bureaucratization and disenchantment," Jacques Ellul "technological domination," Herbert Marcuse "rational one-dimensionality," and Robert Bellah "utilitarian individualism."

The second theme concerns the changing nature of

personal and family life and of personal relationships. These developments have been variously discussed as a tendency toward what Christopher Lasch, Richard Sennett, and others have called "narcissism," Daniel Bell "hedonism" or "antinomianism," Arnold Gehlen "subjectivism," Phillip Rieff "therapeutic mentality," and Bellah and his associates "expressive individualism." As numerous studies have made clear, these tendencies are particularly prominent within the highly educated upper-middle classes.

If these cultural tendencies have been described accurately, even in their general contours, they fit comfortably with the formal ideology of movement humanism. That is, the latent moral ideology and the formal tenets of the sectarian movement share a common ideological structure. That, in turn, means that the structure of contemporary culture provides a reinforcing context within which humanistic ideology, both formal and "folk," becomes credible if not common sensical to an increasing number of people.

Education and the Dominant Ideology

The claim that secular humanism is a pervasive ideology in American public life that has sometimes received the unofficial — and unconstitutional — support of the state was tested in 1986 in *Smith v. Board of School Commissioners*. The case pitted a coalition of evangelical Protestants, conservative Catholics, and other "theists" against the Mobile, Alabama, board of education backed by, among others, the American Civil Liberties Union and the People for the American Way. The theists argued that many of the textbooks used in the county's public schools actually promoted the "religion of secular humanism" in violation of the establishment clause of the First Amendment. These claims were widely discredited in the media and by activists, but viewed from a social scientific perspective broader than that of partisan politics, their credibility is harder to ignore.

First, public education is one of the massive public bureaucracies of modern society and, as such, has been subject to the same kind of secularization as other public bureaucracies. Second, evidence indicates that there is a certain affinity between the ideological content of public education and the interests of certain cultural elites and the government.

Since its inception the public school system has essentially constituted a government monopoly over mass education, and therefore treats education from a particular perspective. Though that perspective may have changed over the course of 150 years, this point is as true today as it was in the early 19th century. A comparison may be instructive. In private schools, the curriculum tends to reflect the interests of parents who pay tuition directly to the schools. If parents are dissatisfied and withdraw their children, the institutions would decline and collapse.

Public schools, on the other hand, are not so directly dependent on, and beholden to, parents; funding for public schools comes from taxes, and school goals and regulations are set by district, state, and federal officials. Public education, then, is more likely than private education to reflect the interests of the secular bureaucracy of the modern state. It is also more likely to reflect the vested interests and cultural orientation of a larger category of cultural elites — not only those who design educational curricula, but other arbiters of social taste and opinion such as journalists, lawyers, professors, and politicians.

Understood from this perspective, it is not surprising that almost all references to theistic religion have been omitted from textbook descriptions of American history, life, and culture. It is also not surprising that public school curricula tend to reflect an emphasis on the individual as the measure of all things and on personal autonomy, feelings, personal needs, and subjectively derived values — all of which are independent of the transcendent standard implied in traditional theism. To the extent that these tendencies exist, public education arguably shares a common cultural orientation with modern humanism. To the degree that public schools advance these perspectives without respect for cultural traditions that might dissent, the claim that the principles of the establishment clause are violated gains credibility.

Interestingly, some of the more militant and secularist protagonists of humanism have recognized and reveled in the link between public education and humanism. Charles Francis Potter, for example, one of the signers of the Humanist Manifesto I, wrote in 1938: "Education is thus a most powerful ally of Humanism, and every American public school is a school of Humanism. What can the theistic Sunday schools, meeting for an hour once a week, and teaching only a fraction of the children, do to stem the tide of a five-day program of humanistic teaching?"

"I think the most important factor moving us toward a secular society has been the educational factor," Paul Blanshard wrote nearly 40 years later in an essay in *The Humanist*. "Our schools may not teach Johnny to read properly, but the fact that Johnny is in school until he is sixteen tends toward the elimination of religious superstition."

In many respects, the logic of all this evidence is unsurprising. It falls in line with many of the basic canons of sociological theory and cultural analysis: namely, no knowledge is value-neutral; no knowledge is free of presuppositions. All knowledge is rooted in the social structure in particular ways and reflects, even if indirectly, the particular interests of different sectors of the population. Unquestionably, these canons hold true for the "knowledge" passed on to children in public schools.

The initial judgment in *Smith v. Board of School Commissioners* decided in favor of the theists' argu-

ments, and though it was later overturned, the case raised critical issues about public education and its tendency to reflect the dominant moral ideology of public life. As Harvard professor Robert Coles, the lead witness for the board of commissioners, put it, "I don't know if there is a religion called 'secular humanism,' but there is definitely a 'secular religion' in education today." *Washington Post* columnist Colman McCarthy framed the issue neatly: "A careful reading of the [initial] decision, as against a skimming of news accounts of it, reveals that Mobile families had a fair grievance: that what was taught in classrooms about religion was impeding the teachings of mothers and fathers at home about religion. What's wrong with that complaint?"

In Search of Public Justice

In the final analysis, the reality of secular humanism and its status and influence in contemporary life is much more complicated than most leading activists — on either side of the question — would have. Secular humanism in American public life is neither an all-embracing and self-aggrandizing religion conspiring to control American institutions nor a fiction manufactured by the religious right as a scapegoat for all the problems they see. Where secular humanism can be described accurately as a sectarian religion, it has almost no effect on American institutions. Where it does have an impact, as the latent moral ideology of the intellectual classes, of the media, of public education, and the like, it does so as a relatively diffuse moral ethos rather than as a religion.

To describe secular humanism as a relatively diffuse moral ethos is not to say it is culturally impotent. Quite the opposite. Indeed, the evidence indicates that it occupies much the same place in American public culture as nondenominational Protestantism did in the 19th century. Because of its specific role in contemporary public school curricula, it actually enjoys the status of a quasi-establishment.

There is deep irony in this fact. Evangelicals and other theists who protest against the quasi-establishment of secular humanism have taken roughly the same position as the Catholic hierarchy of the mid-19th century in their protest against the quasi-establishment of Protestantism. For their part, ideological progressives such as the American Civil Liberties Union and the People for the American Way occupy much the same position assumed by their evangelical Protestant counterparts a century before. They share a strong interest in maintaining both the status quo and their own dominant position in it.

What does all of this mean for the conduct of law on

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this issue? The courts must either articulate a constitutional double standard or strive toward definitional consistencies; that is, apply the functional definition of religion to the establishment clause just as they have to the free exercise clause. The latter option would mean that secularistic faiths and ideologies would be rigorously prohibited from receiving even indirect support from the state. That, needless to say, would have enormous implications for the organization of public education, for it would require the state to give up its monopoly control over education. At the least, it would establish pluralism as an organizing principle of public education. The potential consequences of this outcome alarm many knowledgeable progressives, not least (the

sociologist of knowledge might infer) because it would operate counter to their interests. They therefore vigorously reject consistency in favor of what they themselves call a double standard — a functional definition of religion for free exercise purposes and a substantive definition for establishment purposes. Without such a double standard, Laurence Tribe has reasoned, every humane government program could be "deemed constitutionally suspect."

Yet, if the courts adopt such a double standard, what possibly could provide a fair set of rules for value-grounded debate? Debating whether a cultural system or faith is religious becomes an exercise in arid legalism that is almost beside the point. If part of the moral purpose of the religious liberty clauses was to establish a mechanism of public justice whereby no one faith or ideology would have a government-based advantage over another, how could there be fairness between traditional theists and nontheists or progressive theists if the courts do not acknowledge the incalculable advantages afforded to the latter through such a constitutional double standard?

In the end, the religion clauses of the First Amendment concern both rights and responsibilities — the right to live according to the convictions of conscience without state interference and coercion, and the responsibility to respect that right for others, including the repudiation of all direct and indirect patronage of the state, whether for others or oneself. Today the religion clauses must contend with social and cultural conditions that are fundamentally different from those that confronted the framers. But the ideal of public justice that those clauses aspire to establish has not changed. Reconciling that ideal with novel social conditions, and in particular the place of secular beliefs in the current expansion of pluralism, is the challenge that we, the heirs and benefactors of the founders' moral project, must now face. □

Henry Brandon

In the European Driver's Seat: The EC or Germany?

Henry Brandon, guest scholar at Brookings and columnist for the *New York Times World Syndicate*, was the chief American correspondent for the *Sunday Times of London* from 1949 to 1983. He is the author of several books, most recently a memoir, *Special Relationships*, from Roosevelt to Reagan (Atheneum 1989).

Until the revolutionary events of 1989 changed the face of Eastern Europe, the 12 Western nations that together compose the European Community (EC) were moving steadily toward achieving their stated goal of creating a single market by the end of 1992 with greater economic and monetary cooperation to follow. At their headquarters in Brussels, EC officials were confident that the new Europe envisioned by Jean Monnet at the end of World War II would not only soon be realized but would also fill, as he once put it, "a vacuum on either side of which are the two great dynamic forces of Communism and American capitalism."

Only last September Jacques Delors, who is expected to remain as president of the European Commission until 1992, said that establishment of the single market — the removal by the end of 1992 of all internal physical, fiscal, and technical barriers to the flow of goods, services, and capital among the 12 EC members — was not in doubt. Any discussion, he said, would be about "how" and "when," not about "whether."

But with the collapse of communism in Eastern Europe and the possibility of German reunification, the questions how and when have taken on new dimensions. Has the plan for the single market, designed to provide a base for European union, a center of stability, and the tie to bind West Germany closely to the West, been overtaken by events? How will the new situation in Eastern Europe affect the EC's plans for greater unity among its

members? Indeed, the changes in Eastern Europe have called into question the very character of the European Community in the form in which it was first conceived.

As Delors put it in January: "The Community is running enormous risks because the pace of events has fueled the debate on European integration. I have heard it argued in some quarters that the Community, as a product of the Cold War, should die with the Cold War . . . I interpret this variously as a return to facile nationalism or a temptation to play the Metternich card. It is as if a changing world had created openings for those driven by vanity and for would-be statesmen seeking to play yesterday's hand."

The Single European Act

Jean Monnet, the creative force behind the EC, was inspired by the desire to avoid a repeat of the pre-war European nationalism that had had such disastrous consequences for the continent and by his conviction that if Europe was to assert itself in a world of superpowers, it had to become a superpower itself. In fits and starts, the EC has been working to turn Monnet's vision into reality ever since the first six members, Belgium, France, Italy, Luxembourg,

the Netherlands, and West Germany, signed the Treaties of Rome establishing the Community in 1957.

With the addition of Denmark, Ireland, and the United Kingdom, the six became the nine. The tenth was Greece, which joined in 1981. Spain and Portugal joined in 1986, the same year that the EC adopted the Single European Act, which set the objective of a single internal market by the end of 1992 — a genuine common market of 320 million people with a combined gross national product of \$4.6 trillion, nearly the same size as the U.S. GNP. Because the EC also stipulated that most of the directives necessary to set up the single market could be passed by qualified majority vote rather than unanimously, there is little doubt that Europe 1992 will come to pass, although some delays can be expected.

The Single European Act also committed the EC members to increase their cooperative efforts on matters of economic and monetary policy. But economic and monetary union, one of Delors' key priorities, will experience rougher going and its achievement is less certain. The first stage aims at drawing all EC currencies into the European Monetary System (EMS), which was set up in 1979 primarily to stabilize

currency exchange rates. The United Kingdom, Greece, and Portugal are not now members of the EMS. The second stage would set up a central bank to subsume all existing monetary policymaking bodies of member nations. The final stage would lead to the fixing of exchange rates and to constraints on national budget decisions.

Until West German Chancellor Helmut Kohl raised the "German question" and stressed that a reunified Germany would have to be integrated into "the architecture of Europe," the one persistent obstacle to greater integration in Europe has been Margaret Thatcher, the British prime minister, who has so far refused to join the European Monetary System and is opposed to the very idea of a European monetary union.

Thatcher likes to point out that Britain has had no exchange or capital controls since 1979, that it maintains a genuinely free market in financial services, and that it enjoys the gains to be had from being part of the European free market. But she also insists that she does not want to be pushed into some kind of a European federation with real political teeth. To her such a federation would risk having socialists on the continent impose their corporate policies on the EC, including the United Kingdom.

The prime minister's deep suspicions on this score were reinforced in 1988 when Delors, himself a socialist, rashly chose to address the British Trade Union Congress. The Labour party has since dropped its antagonism to the EC, for domestic political reasons, and because the party concluded that it has potential allies at the Brussels headquarters.

In contrast to their prime minister, who is motivated by her deeply ingrained beliefs in national sovereignty and all that it implies, Britain's business leaders and her former, and still influential, chancellor of the exchequer, Nigel Lawson, favor British membership in the EMS. They worry that if Britain does not join the EMS, it will be left

in the cold, unable to exert any real influence on the future direction of Europe. They are fearful that Britain's full participation in the EMS may have to await Thatcher's retirement. But there exist the first indications of an adjustment in her stance — still more a matter of tone — in the light of the changing attitudes among her British supporters, and she may yet be coaxed in.

West Germany's political power has already made it 'first among equals' within the E.C.'s councils and deliberations, and there is little doubt among EC members that the path to greater European unity will depend, above all, on the path and pace West Germany is willing to sanction.

The German Question

Meanwhile, Thatcher takes comfort in her present view from the hints at indecision in Bonn whether to opt for a "broader" or "deeper" economic integration, which would let it keep the back door open for East Germany, unified in some way with West Germany, to join the EC. Much of the European public is apprehensive about German reunification, not only because of Germany's role in the two world wars, but also because of the potential economic and political juggernaut that unification would create.

West Germany's political power has already made it "first among equals" within the EC's councils and deliberations, and there is little doubt among EC members that the path to greater European unity will depend, above all, on the path and

pace West Germany is willing to sanction. Reunification with East Germany is likely to make that power even more unassailable.

Most of the EC member governments have, however reluctantly, swallowed these concerns because they recognize that reunification of the two Germanys is a virtual certainty and that opposing it publicly would be politically unwise. They would like to see even a reunified Germany inside the EC rather than unrestrained outside it.

Delors certainly reached that conclusion earlier this year when he said that East Germany represented a special case in Eastern Europe and could join the EC before 1993 should it so wish, provided that reunification with West Germany is attained through self-determination.

In view of the deep apprehensions he expressed about the national antagonisms that "may well re-emerge in Europe," Delors may have hoped his proposal would entice Chancellor Kohl to choose a "deep" commitment to the European Community to ensure that the EC could not be pulled apart. Or to put it into geopolitical rhetoric, that the EC, not Germany, would dominate in Europe.

Kohl, asserting his own political interests, turned down a recent attempt by French President François Mitterrand and Italian Prime Minister Giulio Andreotti to speed up the timetable for the Community's monetary union by advancing the date for a European summit from next December to July. The incident reflected not only Kohl's power, but also the growing nervousness in Brussels over the repercussions of German unification on the future of the European Community. The fear is that Bonn, in view of Germany's new trading interests in Eastern Europe, may lean toward a looser European integration.

Another issue, which is bound to come up, is whether a unified Germany, based on the added East German population, should get another 18 seats in the European Par-

Delors and the European Commission

The driving force behind the European single market and the proposed monetary union is Jacques Delors, a French socialist who as president of the European Commission is one of the continent's most important, but also least known, statesmen. Delors has been remarkably successful at facilitating agreements among the EC member nations, whose interests, views, and politics often conflict. Yet the sources of his power are hard to define.

One obvious source is the strong backing he can count on from the French government. But it is his wide-ranging experience in government that qualifies Delors for the job. His working-class origins and his services as an executive officer at the Banque de France and as minister of economics and finance in the cabinet of Prime Minister Jacques Chaban-Delmas all provided him with a fertile training ground. Delors behaves more like a bureaucrat than a politician, more like an organizer than a mobilizer, more like an infighter than a leader. Being shy, he is not a media star or a convincing performer at press conferences. But his vision of what a united Europe might be has injected a new dynamism into the EC and helped to erase the old, debilitating Europessimism from people's minds.

The European Commission Delors heads is perhaps the most unique institutional device ever invented in Europe. The commission, which serves as the executive arm of the EC, is based loosely on the philosophy of Claude Henri de Simon, the French social reformer of the early 19th century who argued that nations should be governed only by the wisest and most skillful technocrats. The commission is indeed not directly accountable to the member governments because its tasks were considered too difficult to accomplish under democratic rules. Though the commissioners are appointed for four-year terms by their governments, they are not allowed to take instructions from those governments, and they may be removed only by a two-thirds majority vote of the European Parliament.

However, it is becoming increasingly obvious that the more the Community refines the general design for union envisioned by Jean Monnet and his collaborators and develops into a framework for the sharing of sovereignty by consent, the more democratic accountability will be demanded of the commission. A likely step in this process of democratization — and it should be speeded up — will be election of the commissioners, or at least the president, by the European Parliament. That would make the commission directly answerable to the parliament, which itself is elected by voters in the member states.

Giving the commission democratic legitimacy will not solve the difficult problem of how that legitimacy will coexist with national parliaments and the Council of Ministers, the EC's main decision-making body. Which matters should be taken up by the EC and which should remain national or local issues is another difficult question still being tested by the commission. Eventually, a federal system will most likely have to be introduced to give the commission the authority and legal standing it will need in an integrated Europe.



Jacques Delors, president of the European Commission

liament. That would give Germany a total of 99 seats out of 518.

In the same speech, delivered to the European Parliament in Strasbourg, Delors made it clear that immediate EC membership for other countries of Central and Eastern Europe was out of the question. They are neither economically nor politically ready to "embrace pluralist democracy and operate a market economy," he pointed out, noting that "it took Spain and Portugal seven years to prepare for Community membership." Meanwhile, the EC is playing an important role in Eastern Europe by providing and coordinating food, medical, and financial aid and by offering its experience in economic cooperation.

Delors also rejected demands for including EFTA, the European Free Trade Association, in the EC complex. (The six members of EFTA are Austria, Finland, Iceland, Norway, Sweden, and Switzerland.) "There will have to be some sort of osmosis between the Community and EFTA to ensure that EFTA's interests are taken into account in major Community decisions," Delors said, "but this process must stop short of joint decisionmaking."

Some sort of osmosis between the EC and the United States has also been proposed, first by President Bush in May 1989 and more recently by Secretary of State James A. Baker III. Speaking in Berlin on December 12, Baker proposed negotiation of a treaty to strengthen the "institutional and consultative links" between Washington and the EC.

But some members of the EC interpreted that proposal as an attempt to muscle in on decisionmaking in the Community, making it clear that strong resistance is likely to greet any U.S. attempt to become a participant in EC deliberations on issues that have a direct bearing on U.S. interests. Delors in his Strasbourg speech seemed to agree that "there is something ambiguous about linking transatlantic partnership with European integration." But he added that he "rejoiced" at U.S. willingness "to step up cooper-

ation" and that he would submit proposals for closer cooperation sometime this year.

The EC and the East

However much the moves toward democratization in Eastern Europe are being welcomed in Brussels, they have also had an unsettling effect because their impact on the future of the EC cannot be predicted. The jubilations over the sweeping changes must not lead the West to ignore the political dangers inherent in the dire economic conditions prevailing in Eastern Europe. Lack of new investment, massive debt, stagnant growth, and low export earnings (because of shoddy goods) will all hamper the improvement of living standards that Eastern Europeans expect to come hand-in-hand with their new freedoms. These conditions, as well as the multi-party elections scheduled in many of these countries, could lead to setbacks the new governments might find hard to cope with.

Just how the emerging democracies of Eastern Europe might therefore fit into or relate to the EC is still wide open. Last July Soviet President Mikhail S. Gorbachev, speaking before the Council of Europe in Strasbourg, called for a "common European home" as the next phase in the evolution of post-Cold War Europe. Gorbachev offered no details, but his common home sounded more like a concept to overcome the division of Europe, more an attempt to nudge history and the members of the EC into a direction which will ensure that the Soviet Union has a voice in the process and does not become isolated on the periphery of Europe.

For his part, French President Mitterrand has suggested the concept of a "grand European confederation," but in Delors' view such a confederation will not come into being until the EC achieves political union. He talks instead about a slightly different vision, a "European village" built around the solid house of the EC, reinforced by an

expanded political structure. He believes that the EC must remain the "rock of stability," for Europe.

But, Delors admits, progress toward the goals of the Single European Act has been disappointingly slow. He confesses with a touch of irony that he looks with some envy to the East, where the course of history was changed in only a few months. The Single European Act went into effect in July 1987, yet of the 86 EC directives on the single market that should already be in force, only 14 have been adopted by all 12 member states. Pressing ahead with economic and monetary union has its limitations without the single market in place.

Delors has mused aloud about the slowness to act within the EC. "As the people of Central and Eastern Europe take their destiny in hand, I find myself regretting that our venture does not have more popular support," he said. Martin Bangemann, the EC's internal matters commissioner, confirmed that "the most difficult problems lie on the level of putting into effect and applying Community measures in the member states."

Why indeed are the EC and its member states not more galvanized by the new challenges? Is it because the dangers of moving from the history of warfare to the history of economic and social competition are unexciting? After all, they too deal with life and death. Or are such issues as the reorganization of working hours, the free movement of people, the removal of tax frontiers, and the many other measures involved too complex to arouse much public interest?

"As the superpowers map out their vision of our continent," Delors lamented in concluding his address to the European Parliament, "the question is this: is Europe to be a mere spectator or is it to play an active role in shaping tomorrow's world?" Indeed, Europe, faced with new and unanticipated uncertainties, needs the kind of economic, political, and social anchor a more unified EC could provide. □

Navigating the Maze of New College Financing Options

Arthur M. Hauptman

Arthur M. Hauptman is an independent consultant specializing in higher education finance and federal budget issues. He is the author of the recent Brookings book, The Tuition Dilemma: Assessing New Ways to Pay for College, from which this article is drawn.

Virtually everyone involved with higher education knows that traditional student aid programs and family incomes did not keep pace with college tuitions and other fees in the 1980s. As a result, many states, colleges and universities, philanthropists, and the federal government have begun to experiment with new ideas to help students and their families pay for college.

The diversity of the many innovative financing plans that have emerged reflects the wide differences in the objectives to be met. The desire to increase incentives for parents and students to plan ahead for college has resulted in a boom in savings incentive and tuition prepayment plans. The need for adequate student credit opportunities has led to the creation of less-subsidized federal student loan programs as well as numerous state, institutional, and private loan efforts. The high priority that many place on raising the participation of low-income and minority students in postsecondary education is evidenced by the growing number of efforts to ensure that these students will have the support, financial and otherwise, to attend college. Those interested in improving quality have sought ways to expand aid awarded on the basis of academic achievement. Those who place a high priority on development of good citizenship and societal values lean toward proposals that link aid to the performance of community or national service.

As with most other issues of public concern, the resources available fall far short of what is needed to fulfill all the worthy objectives. Policymakers interested in using the new financing mechanisms and the available funds most effectively must determine which objectives are most important and therefore deserve the greatest investment. They must also consider the appropriate role of federal and state governments, educational institutions, foundations, the private sector, and students and parents themselves. Where should each of these actors play a principal role; where should they play a supporting role? This article attempts to sort through this maze of new roles and responsibilities for college finance.

Savings and Tuition Guarantee Plans

Much of the effort to create new financing options has centered on savings plans and tuition guarantee plans, in which parents buy a contract when their children are young that ensures tuition payments when those children are ready to enroll in college. The fundamental issue regarding all of these plans is whether they will, in fact, result in additional savings. The answer appears to be, probably not much. The incentives may well change the mix of assets that parents and students use to save for college, but altering the overall rate of saving would require a much larger financial incentive than the modest ones being offered in the plans developed thus far. In addition, the subsidies provided

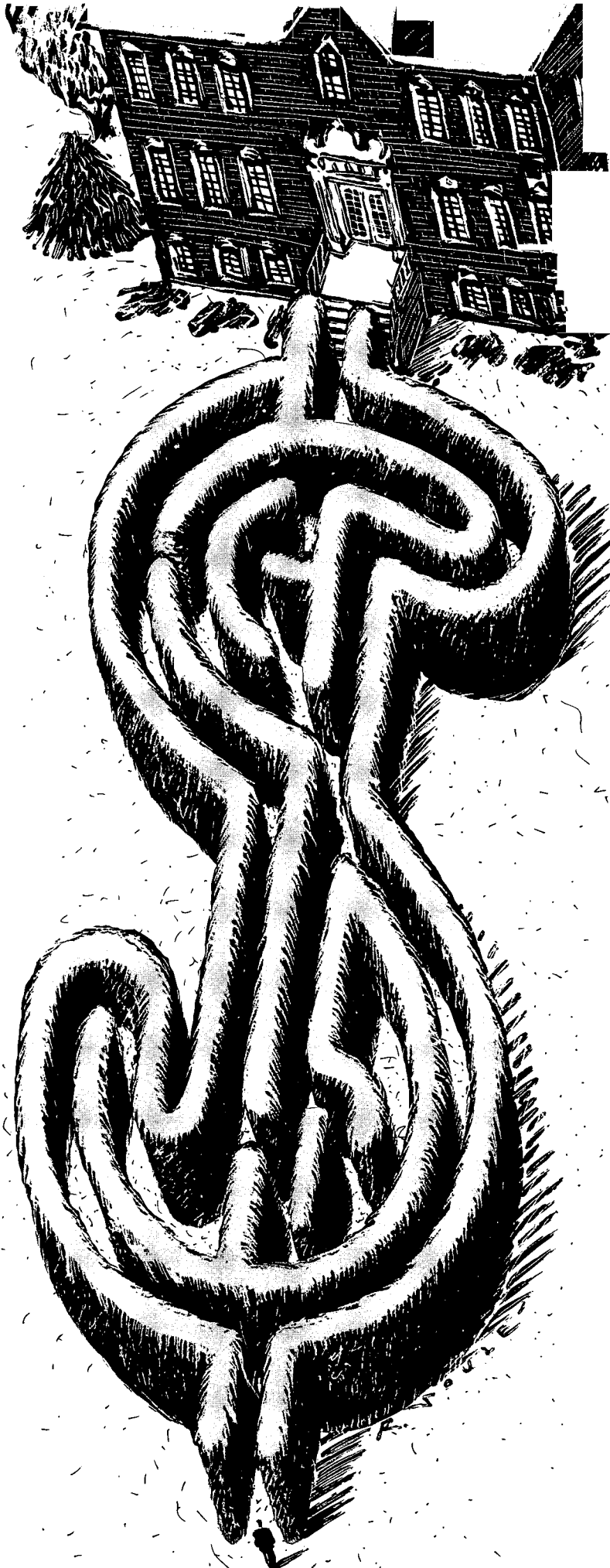
through most savings incentive and tuition guarantee plans will normally accrue to wealthier families because they are the ones who have the resources to save. This skewed distribution of benefits argues heavily against any plan that entails large public subsidies.

A modest governmental commitment may nonetheless be worthwhile. First, it would encourage parents to save for their children's education rather than be caught unprepared for the bill. Moreover, to the extent that parents do save, their need for financial aid will be reduced, which will relieve at least some of the political pressure for increased funding of the student aid programs. Along the same lines, if these savings plans encourage middle-class families to save more, some funds may be freed up for the neediest students whose families are unable to save. Some refer to this as the trickle-down theory of college finance. Finally, if equity is a concern, there are ways to reduce the share of benefits going to well-to-do families, although these restrictions typically add to the complexity of the plan.

Private financial institutions are the primary providers of college savings funds and should remain so for at least two reasons. First, the private sector has the most expertise and experience in developing and marketing mutual funds, tax-exempt financing, zero-coupon bonds, and the other financial instruments that readily lend themselves for use in saving for college. It is probably better to draw upon this private sector experience than to have governments or colleges try to develop their own expertise in this area. Second, for the middle- and upper-income families who are most likely to participate in and benefit from savings and tuition guarantee programs, private plans with little or no government subsidy remain the most appropriate savings vehicle.

The primary role of the federal government in the area of savings should be that of promoter and sponsor rather than subsidizer. The government should encourage families to begin saving earlier for college and should provide information on savings opportunities that exist nationwide. But the federal budgetary commitment to college savings incentives should be minimized; instead, federal funds should be targeted on the neediest students.

Two steps could be taken immediately to encourage savings and target needy students. A federal law enacted in 1988 exempts from taxation interest on U.S. savings bonds bought after 1989 so long as the proceeds are used for college tuition and fees. Fairness would be improved if the tax exemption were changed to a provision in which the interest paid on the bonds would be higher (and taxed) if used for college expenses. Such a subsidy would be more valuable to lower-income families than a tax exemption of similar size. And there would be one less tax loophole. The current tax treatment of gifts to children, which discourages saving for college for younger children, should also be reconsidered.



There seems to be general agreement that the federal government should provide the assurance of repayment to lenders that students without adequate capital cannot. It is not as obvious that the existing guarantee arrangement is the most appropriate one.

By the end of 1989 more than half of the states had passed legislation that either provides tuition guarantees or creates incentives for college savings. Most have opted for savings incentives over tuition guarantees. This is a trend in the right direction, since most states are justifiably hesitant about committing themselves to the possibility of large contingent liabilities and are worried about other potential adverse and inequitable effects of tuition guarantees.

Another possible role for the states, though none has yet done so, is to provide small subsidies for federal, institutional, or private savings plans. For example, states might supplement the return on the federal savings bonds used to pay for college expenses. These subsidies should be restricted to students from low- and moderate-income families, perhaps by targeting the additional interest payments on those students who are eligible for state grant assistance. The states, like the federal government, can also promote or sponsor nongovernmental savings plans without a commitment of taxpayer dollars.

Colleges and universities have played a minimal role in the development of savings plans and should continue to do so, having neither the resources nor the expertise to justify a greater involvement. Moreover, to the extent that the benefits of such a plan would be limited to the institution(s) that participated in its development, choice for students and their parents would be restricted rather than expanded. The one reasonable function for institutions might be for consortia of them to sponsor or promote savings plans to encourage more savings, regardless of which college or university a student chose to attend.

Overall, it is not realistic to expect that public plans designed to increase college savings will or should as-

sume a substantially larger role in financing postsecondary education. The large subsidies needed to produce significant additional savings would probably not be cost-effective. But modest subsidies and heavier promotion of savings plans could increase savings moderately and relieve some of the pressure on the student aid programs by reducing the financial need of some middle-class families.

Alternative Loan Programs

The recurrent concerns expressed about the growing imbalance of loans versus grants suggest that student loans should be de-emphasized and grants raised to a higher priority. But that is unlikely to happen in the near future because the amount of funds needed to increase grants sufficiently to redress the imbalance is so large. Moreover, the growing costs of college make it impossible simply to slip back to the "good old days" when loans played a minor role in the financing of higher education. It would be more realistic to examine how the growth in loans might be restrained, their costs minimized, and repayment burdens made more manageable.

By virtue of its long involvement and substantial investment in the Stafford program (formerly known as the Guaranteed Student Loan, or GSL, program), the federal government is likely to continue to guarantee private sector loans to both students and their parents. There seems to be general agreement that the federal government should provide the assurance of repayment to lenders that students without adequate physical capital cannot. It is not as obvious, however, that the existing guarantee arrangement is the most appropriate one.

The federal government pays almost all the costs associated with defaults under the Stafford program. That could be modified by changing the loan origination fee that students now pay into a default fee, which would offset federal costs at least in part. Lenders and institutions that participate in the program should also be required to share some of the risks, while the federal government would continue to serve as the backup guarantor. In effect, the federal government would act more like an insurer, who would use the premiums paid by participants to pay default costs, than like a full guarantor.

Agreement that the federal government should continue to act as a loan guarantor does not mean that it should also continue to subsidize loans at the same level it now does. The high degree of interest subsidy in the Stafford program — each loan costs 30 to 50 cents per dollar loaned — has made these loans attractive to students and their parents and has therefore been a significant factor in the growth of student loans. It can also be argued that the costs of paying for these interest subsidies have prevented greater funding of the student grant programs. Furthermore, the

high degree of subsidy makes it more difficult for states, institutions, and the private sector to establish competitive alternative loan programs. These factors argue for a reexamination of how much subsidy should be provided, and also for greater use of the PLUS (parent loans to undergraduate students) and SLS (supplemental unsubsidized loans to graduate and professional school students) programs because they entail substantially lower federal costs than GSL.

The federal government might also investigate extending its role as a source of loan capital. The decision in 1965 to use private loan capital for the GSL program was motivated by a set of factors that may not be as relevant today. The use of federal capital, whether in the form of direct appropriations or borrowing, could entail smaller federal costs than those currently paid because the subsidy to private lenders to encourage their participation could be sharply reduced or entirely avoided.

The possible use of the Social Security trust funds as a source of student loan capital is particularly intriguing because it would provide a means for private investment of the trust fund with a federally guaranteed rate of return competitive with other market opportunities. The notion of repaying these loans through the payroll tax mechanism should also be considered because it would avert many of the problems that can come up under an income tax-based system of repayment.

Current or projected levels of borrowing, however, probably do not justify introducing a full-scale income-contingent approach. Most borrowers do not find repayment a problem and should not be asked to subsidize those borrowers who are experiencing difficulty. The incidence of defaults should instead be reduced through a program of low-income insurance for those borrowers whose repayment obligations exceed a reasonable proportion of their incomes once they complete their education.

Concerns about the size of the federal budget deficit and a growing conviction that the federal loan programs require some major adjustment may mean that states, institutions, or foundations will become more involved in loan programs. Rather than provide loan capital directly, it would seem more appropriate for them to concentrate on subsidizing privately financed loans, in many cases substituting for the federal subsidies. For example, institutions or foundations could pay all or a portion of the in-school interest for borrowers who cannot participate in the federally subsidized programs or whose borrowing needs are not fully met by the federal government. States, institutions, or foundations could also forgive all or part of the loans for students who enter designated professions or who opt for public service over more lucrative private endeavors.

Any expansion of nonfederal loans should be accompanied by a coordinated effort which ensures that

borrowers can consolidate repayments of the loans they borrow under different programs. Otherwise, the complexity and confusion will negate the benefits of opening up alternative sources of capital and subsidies. It would be good public policy to institute better coordination of loan repayments among different programs now, even without any other change in the student loan structure.

Assured Access Strategies

The recent and troubling lack of progress in improving the participation rates of low-income and minority students has frequently been blamed on a decline in the availability of student aid for these students. The facts may not bear out the theory. Although the maximum levels of aid have not kept pace with inflation, enough funds are available so that most impoverished students can afford to attend public institutions if they so desire. Even so, participation rates have not improved appreciably and may even have declined. Consequently, a number of efforts have been designed to improve access for these groups, primarily by combining support services with promises to pay the costs of attending college.

Eugene Lang, a wealthy industrialist and philanthropist, is often credited with spurring the most recent efforts to assure access to economically disadvantaged students. In 1981 he promised the pupils of a sixth grade class in East Harlem that if they graduated from high school and were accepted at college, he would pay their way. Lang's impromptu experiment and other, less publicized efforts have reinforced the notion that to be successful, assured access must involve not just money, but hope, support, and the personal touch.

Under Lang's leadership, the philanthropic sector has assumed a principal role in the development of assured access efforts across this country. But the task exceeds the financial capacity of any single sector. At a minimum, several billion dollars each year would be required to meet the need. Philanthropic efforts for this purpose now total several million dollars annually. Moreover, the randomness of individual philanthropists adopting classes of students does not represent a particularly reassuring policy response. Some greater institutionalization of the concept is desirable.

The states would appear to be the most likely candidates for the successful adoption of a complete assured access strategy. They are less removed from the students than the federal government but have greater resources than foundations or the institutions themselves. They also control the tuitions charged at public colleges and universities, which are the primary tool for providing access to higher education in the United States. Finally, the aid that a state or institution provides usually serves as the final piece of the puzzle in determining the size of a student's aid package. These

marginal dollars often are critical in a student's decision about where to go to college.

Short of a massive funding increase for Pell grants, the basic federal grant program, the federal government cannot provide assured access. Nor is it clear that greater funding of student aid is the sole answer. The other critical components in the Lang approach — earlier awareness of aid eligibility and better support services — appear to be equally important.

The federal government can help in that regard by serving as the “guarantor” of aid early in a student's high school years. Now students and their families do not know whether they will be eligible for aid until the spring before they are ready to enroll; for many it is even later. The federal government could determine aid eligibility for economically disadvantaged students as early as the seventh grade. Students could apply for eligibility, or they could be considered eligible for student aid if they were eligible for some other form of public assistance such as welfare or the school lunch program. This early assurance of aid would not increase federal costs very much. Available data indicate that the economic circumstances of disadvantaged youth do not change much over time. The vast majority of students deemed eligible for aid in the seventh grade would still be eligible when they reached college age.

The federal government can also help to assure access by strengthening its commitment to the TRIO programs, such as upward bound and talent search, that provide student support services. More funding is necessary so that a higher proportion of eligible students can receive this important assistance. TRIO funding should perhaps increase faster than funding for student aid to increase the effectiveness of the stu-

dent aid dollars. And TRIO funding should be redirected. Instead of going almost exclusively to institutions with established programs of support services, TRIO funds should be used to provide matching funds to those institutions with high concentrations of disadvantaged students that have demonstrated a willingness to commit more of their own funds to these efforts. Federal funds would “reward” those institutions that made the effort to enroll and, more important, to retain the most economically disadvantaged students.

The main responsibility for assuring access to disadvantaged students should, however, remain with the colleges and universities. Philanthropic, state, and federal efforts can only provide the funds and some direction about their use. Whether students actually enroll and complete college depends ultimately on the commitment of the institution at which they enroll. With or without government funds and incentives, colleges and universities must increase the support services they provide to improve both the postsecondary participation and retention rates of economically disadvantaged students.

Merit-Based Aid

In the 35 years since a group of colleges and universities decided to promote equal educational opportunity by awarding grants based on a student's financial need, merit-based aid has gone from the predominant to the subsidiary form of financial assistance for undergraduates. This is an appropriate set of priorities if the goal of equal educational opportunity is ever to be achieved. Some expansion of federal merit-based aid at the undergraduate level may nonetheless be justified to reinforce the importance of improving quality. This expansion is particularly justified if it is concentrated on students with high academic achievement who are also financially needy.

Educational institutions should continue to be the primary providers of merit-based aid. They are in the best position to compare the qualifications of applicants and to decide which of their students might benefit most from a higher proportion of grants or an infusion of additional aid over and above need-based assistance. At the same time, colleges should not be encouraged to abandon or reverse the needs analysis principles that have evolved over the past three decades. It is unfortunate that many schools appear to be using merit-based criteria to award a growing share of their own aid as a means of competing for students.

The overwhelming proportion of aid that the federal government provides or guarantees for undergraduates should continue to be based on financial need. Without that commitment, the objective of improving participation in postsecondary education would be meaningless. The federal government could target needy students and place a higher priority on quality by expanding its grant programs that recognize high

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achievers for their accomplishments and awarding the grants on the basis of financial need. The most obvious way to do that is to give nominal awards to people with no financial need, while providing much larger awards to needy students, as determined by the standards that apply in the need-based programs, similar to many private national merit programs.

The proliferation of small merit-based grant programs in the states is also not a positive policy trend. It complicates the application process for students, parents, and aid administrators. More important, if a higher proportion of state dollars are provided on a basis other than financial need, the emphasis on equal opportunity is diluted at the state level. These small programs should be consolidated, and need should be considered in determining awards of merit-based aid.

Linking Aid to Service

After a gestation period spanning several decades, the idea of encouraging young Americans to increase the voluntary service they perform has moved to the front burner of national issues. The spark for this resurgence has been the proposal by the Democratic Leadership Council and related legislation introduced in Congress to create a corps of high school graduates to provide much-needed service in health care, education, environment, and other areas in return for vouchers they could use to pay for college expenses, vocational training, or buying a home.

The debate over this proposal has overshadowed the rapid grass roots growth of service projects on campuses and in communities across the country as well as dozens of other federal legislative proposals to

encourage greater voluntary service. The great diversity in the existing service programs and legislative proposals for expansion makes it difficult to determine the proper role of various organizations in encouraging more service. There are, however, several principles that policymakers could use to choose among the many alternatives.

A first principle is that the locus of volunteer activity should continue to be at the state, local, or institutional level and should not be shifted to the federal government. Second, service programs should not be restricted to students and to a particular time in their lives but should also seek to involve people in the work force and those in retirement. Third, service should not be a prerequisite for receiving student aid. Requiring someone to serve in order to receive aid seems the antithesis of the notion of "voluntary" service. If aid is to be conditioned on service, service should be universal; students from all income levels, not just the poor, should be required to serve.

These principles lead to a concept in which the federal and state governments could encourage community-based service by providing subsidies for the local providers or by enhancing the educational benefits that students receive in exchange for the service they have performed. It is reasonable to expect that students who perform service would receive more aid than students who do not, but that nonservers should still be eligible for aid. Subsidies and benefits should not be focused on any one aspect of the life cycle but should apply to a range of activities covering the period right after high school, during the college years, and afterwards. Finally, to maximize the effective use of resources, federal and state funds should be provided on a matching basis that would ensure the continued effort and expenditure of funds by the organizations that sponsor such activities.

Merging New Financing Mechanisms

The overall benefits to be obtained from any one of the new financing mechanisms might be increased by merging aspects of two or more of the plans. One possibility would be to allow parents or students to borrow on the basis of how much they have saved to meet college expenses. When the amount saved is not enough to pay the total bill, it makes great sense to allow parents or students to borrow using the amount saved as partial loan collateral. Using the savings as collateral would help keep the interest rate lower than it would be on a less secured loan. Some private organizations now offer such a borrowing option, but it accounts for a very small fraction of current student loan volume.

Loans could also be combined with savings by using the amount that one group of parents and students saves as the source of capital for loans for another group of students and families. This kind of arrange-

ment could close the college financing cycle between generations: what one generation of parents saved for their younger children would be used to lend to current students and their parents. If the loan terms are kept to 10 or 15 years, then repayments will be available, with interest to be recouped as savings, when the young children reach college age. A handful of campus credit unions already use a variation of this idea by lending student savings to other students. This concept bears further examination and experimentation.

Savings could also effectively be linked with loans in the way the two efforts are funded. The funds accrued from reducing the interest subsidies on loans to middle-income students could be used to help fund savings incentive programs. Under this kind of trade-off, the overall government financial commitment to students need not increase.

One of the issues surrounding national service proposals is whether enough opportunities for constructive projects exist to justify such an effort. One type of service that seems particularly well suited to high school graduates or college students is to be tutors or mentors to disadvantaged students participating in assured access programs. If the concept of assured access really gets off the ground, the demand for people to serve in these capacities will grow rapidly and could require many thousands of participants.

The most controversial aspect of the citizens corps proposal is its requirement that prospective college students perform service to qualify for student aid. Critics have objected on grounds that disadvantaged students would be forced to participate to be able to pay for college, while middle- and upper-income students could use family resources to pay for school and avoid serving. Of special concern is the provision that would deny federal grants to students who did not perform service. Grants are the primary tool for providing access to higher education, much more so than loans, which are often viewed with suspicion by economically disadvantaged students.

Rather than create a tension between grants and service, an alternative would be to set up a trade-off between loans and service. First, students could choose between service or borrowing to pay all or part of their costs of attendance. Let's say a student had \$6,000 in family or grant resources available to attend an institution that costs \$10,000 in tuition, room, board, and related expenses. To finance the remainder the student could choose to borrow \$4,000, to do service before enrolling or while enrolled that netted \$4,000 in aid, or to do some of both. Students who opted for service would reduce or eliminate their loan burden; thus the trade-off addresses concerns about the growing reliance on loans as the primary form of student aid.

The other possible trade-off between loans and service is in the way the programs are funded. Funds saved by reducing governmental default costs or inter-

est subsidies could be used to provide service opportunities. Restrictions in federal loan subsidies would not only create a more level playing field between different types of loans, but would also make borrowing a less attractive option and might serve to convince students to do service rather than borrow.

An Integrated Package

How, then, to combine the new financing mechanisms into the existing system of postsecondary educational finance to best serve the needs of individual students and their parents as well as the national objective of equal educational opportunity? A package that contained the following items might well receive support among all the groups involved in the financing debate:

- The creation of federal and state savings incentives that are not heavily subsidized, are not tied to guarantees of future tuition levels, and are built on private sector mechanisms.

- Reduced use of loans by lower-income students combined with a program of low-income insurance for students whose debt service exceeds their ability to repay, and possibly more systematic income-contingent repayments.

- Lower federal student loan costs, achieved by reducing interest subsidies on loans for middle-income students and adopting additional default-prevention measures.

- Notification of Pell grant eligibility early in the high school or even junior high school years, coupled with greater targeting of aid on the neediest students and some expansion in program funding.

- Substantial expansion of mentoring and support services through philanthropic efforts and government matching programs to help ensure access to a broad range of postsecondary education for very disadvantaged students.

- Experimentation with programs in which people who perform community service at different points in their lifetimes would receive larger educational benefits than those who do not serve.

- The merging of two or more different plans, such as those that allow students and parents to borrow on the basis of how much they have saved, reward mentoring and support services in assured access efforts, and allow students to trade off between service and loans.

This package of financing initiatives could be implemented at relatively little additional governmental cost if the expansion of grants, support services, savings incentives, and service benefits were paid for largely through a reduction in loan subsidies and defaults. Such a set of changes would not represent a revolution in how postsecondary education is financed in this country. But it would put the system on a much firmer footing to meet the challenges awaiting it in the 1990s and beyond. □

Chile's Return to Democracy

Next page: An illustration of an arpillero, a kind of Chilean applique that traditionally depicts scenes of everyday life. This one, like many made after Augusto Pinochet came to power, refers to the disappeared, asking, "Where are they?"

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Yesterday at the rally, I bought a Chilean flag," Señora Mercedes told me during a visit in her home in a low-income district of Santiago. "For the first time in 16 years, I felt Chilean. . . . I felt free." It was the day after a mass political rally in support of now President Patricio Aylwin. Amid the pre- and post-electoral hoopla that swept the sunny Chilean capital last December, this statement, more than any other, drove home just how much the Chilean people value their return to democracy. For the first time in 19 years, on December 14, Chileans voted in a free presidential election.

Chile has a singular political history. In September 1973 the government of Salvador Allende, the first Marxist in the world elected to national power in a free election, was overthrown in a bloody coup by the Chilean armed forces, led by General Augusto Pinochet. The coup ran directly counter to Chile's democratic tradition — rare on the Latin continent — and ushered in an authoritarian and repressive regime.

Sixteen years later, in October 1988, General Pinochet sought to legitimate his regime through a plebiscite in which Chileans could vote whether or not they wanted him to continue as president. Fifty-three percent voted no, and Pinochet abided by the results — indeed, the constitutional process was allowed to progress beyond the dreams of even the most optimistic observers prior to the plebiscite — and Pinochet became the first dictator in the modern world to give up power at the ballot box. Aylwin took office on March 11, 1990.

Chileans are entering their new democratic era with substantial optimism. Aylwin, a Christian Democrat leading a 17-party coalition, received a strong electoral mandate: 55 percent of the vote compared with 29 percent for pro-Pinochet candidate Hernan Büchi, and 15 percent for independent candidate Francisco Javier Errazuriz. When Pinochet overthrew Allende, Chile was suffering from severe inflation, shortages of most basic goods, and political chaos. Pinochet, strongly influenced by the Chicago School's free-market philosophy, set out to radically transform the economy. It was not a cost-free process. In 1982, for example, GNP fell by 10 percent and the jobless rate was more than 20 percent.

Yet Pinochet's successor is inheriting the strongest economy on the continent. Growth in 1988 was 7.4 percent, inflation 14.8 percent, and unemployment 6.7 percent, figures that take on added significance in light of the quadruple digit inflation and massive unemployment facing Chile's neighbors.

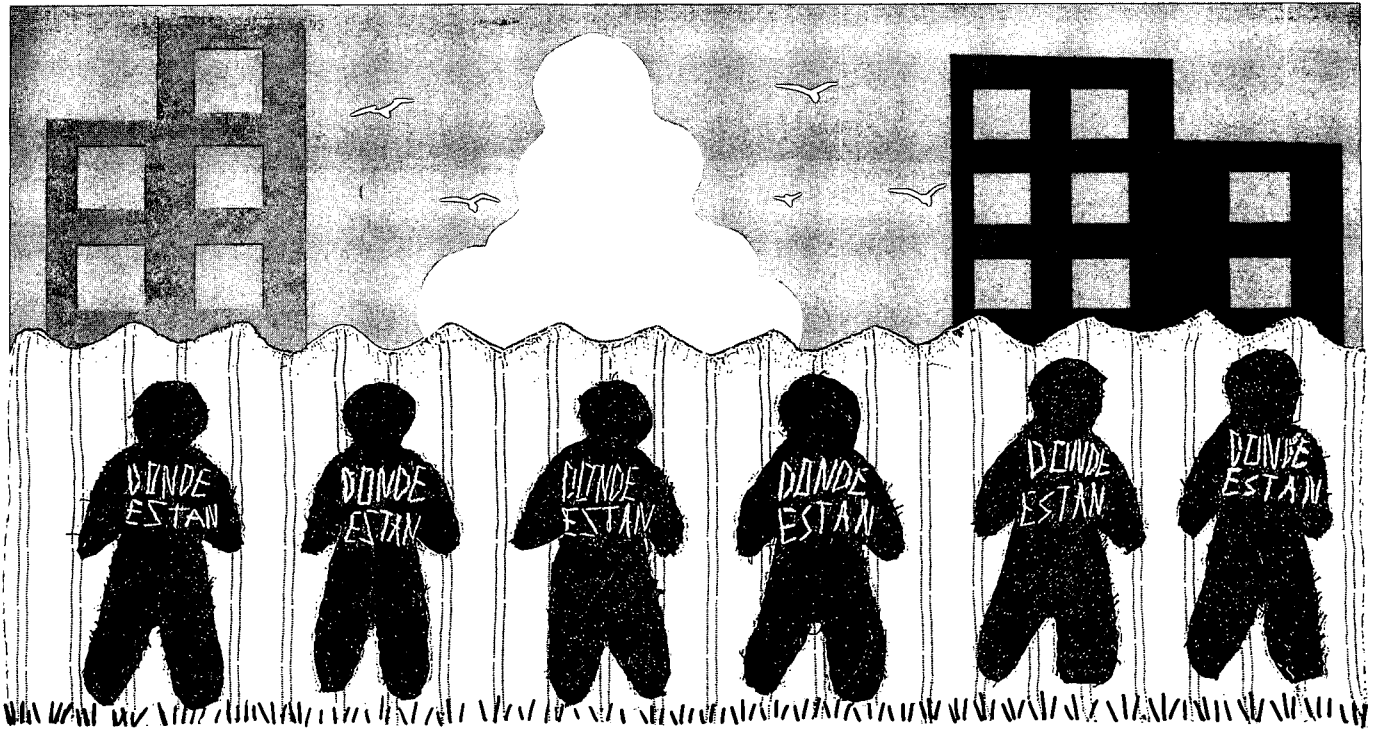
Señora Mercedes' home, for example, considered extremely poor in Chile, would be practically middle class in today's Peru. Early in

December more than 6,000 Peruvians came across the Chilean border just to buy bread to take back to Lima. Attending a political rally or street march in Lima without the threat of a terrorist attack, or at least of being robbed, is unheard of. At pre-election rallies in Santiago, I was never quite sure if I was at a campaign meeting or a Sunday afternoon fair. Indeed, the sense of peace and prosperity that exists in Chile is difficult to find elsewhere in Latin America. If General Pinochet's legacy could be wrapped up this neatly, he could retire quite contentedly.

Privileged Position

Chileans are well aware of their privileged economic position on the continent, and even the Socialists in Aylwin's coalition accept the nation's free market, export-oriented economic model. Issues such as nationalization and debt moratoria were seldom mentioned during the campaign — even though the Socialists (and Communists) were among the major political forces.

Instead, the focus was on fiscal restraint and free trade. Ironically, the two conservative contenders for



the presidency made many more promises to provide increased jobs and free health care and housing than did the Aylwin camp, which confined its campaign pledges to improving income distribution and increasing spending on health and education.

Chile's economic "miracle" does have some cracks: it has left some of the poorest behind. Señora Mercedes, for example, does not have legal title to her home, works as a street vendor, and has no savings, although, she proudly reveals, she has sent all her children through school.

Despite high growth rates in the past few years, the enormous gap between the very rich and the very poor remains. The richest 20 percent held 59 percent of the total income in 1989, while the poorest 20 percent shared 3.5 percent during the same period. This gap has actually widened. In 1969 the wealthiest 20 percent had 56.4 percent of the income; the poorest, 3.7 percent.

More important than the actual figures may be the poor's awareness of this growing inequality and the expectations raised by the return to civilian government. Señora Mercedes, like many others, has high hopes for increased opportu-

nities under the new government.

Yet the Aylwin coalition plans no drastic measures. Its main proposal to narrow the income gap is the creation of a fund for investment in social infrastructure; the main goal is to provide job skills and training for unemployed youth. The fund will depend largely on external credits. It is quite clear that while there may be disagreements within the governing coalition over how to help those who have been left behind, virtually everyone is agreed that solutions must remain within the free market framework.

Remarkable Consensus

As economist Jaime Ruiz-Tagle said recently, "This is the decade of limitations, the same way the sixties was the decade of possibilities." This awareness among both the left and the right of the limitations on the new government has translated into a remarkable degree of political consensus.

A case in point is the confederation of labor unions — the CUT or United Workers Center. Its power drastically curtailed during the Pinochet years, the CUT made clear that it wanted an accord with busi-

ness and government leaders, and just before the elections made a public commitment not to strike for at least a year. That commitment is by no means binding on individual unions, and local union leaders are preparing to press the new government on the wage front.

However, the CUT's enthusiasm for dialogue at the leadership level, as well as a government commitment to sponsor such a dialogue, indicates a relatively peaceful labor relations scene — at least in the short term. Alejandro Foxley, who was in charge of the Aylwin campaign's economic program and will be economics minister in the new government, said recently that the absence of an agreement between business and labor was one of the causes of the crises "that have hit such countries as Argentina, Brazil, and Peru."

Another demonstration of consensus was the resolution of a pre-electoral controversy over the appointment of a board of governors for the nation's central bank. A law passed in October required that an independent board be appointed by December 11. At the time it seemed that Pinochet would have his own people named and thus maintain substantial control over economic

policy well beyond his formal departure from office. As one seasoned observer of Chilean politics noted, "in August it seemed inconceivable that Pinochet would appoint a mixed central bank board, or that the opposition could ever be content with the Pinochet board."

Yet in response to opposition pressure, a moderate and respected economist, Andres Bianchi, was appointed president, and two pro-Pinochet economists and two from the opposition, a Christian Democrat and a Socialist, were named to the board. That incident and the July 31 plebiscite that resulted in popular approval for a variety of reforms to the 1980 constitution both show the extent to which Pinochet's grip on the situation has loosened. He adamantly opposed changes to the constitution, and it is hardly likely that he was in favor of a Socialist serving on the central bank board.

The general initiated the electoral process to legitimate his government; instead he set in motion forces that were largely beyond his control. Clearly he underestimated the ability of the opposition to build and maintain a consensus, not just for the October 1988 plebiscite, but throughout the process of replacing a dictatorship with an elected government. What remains to be seen is whether the opposition will hold together once it is in power.

Human Rights

Few other issues pose problems to the new government as severe as that of retribution for human rights abuses committed by the Pinochet regime. There are also few other issues on which Pinochet has taken such an adamant stance. "If any of my people are touched, I will bring the entire constitutional process to a halt," he declared in October.

Because he remains commander in chief of the armed forces for at least four more years, this is no idle threat. As one conservative politician said, "The human rights issue is one which frightens Pinochet,

and a scared Pinochet is a very dangerous one."

Nonetheless, the number of Chileans affected by direct repression or dictatorial abuses of power is countless. Selective repression has continued, even during the election period. Señora Mercedes recounted how the secret police awakened her family at 5 a.m. a few months before the election, demanding to know the whereabouts of her half-sister, a political activist. "They searched my whole house, everything. I had a book of poems by [the Communist poet] Pablo Neruda on the shelf, and I was so frightened. And my husband . . . they beat up my husband."

Between 8,000 and 15,000 people were executed and 2,000 disappeared during the Pinochet years, according to the Chilean Commission for Human Rights. (These figures are disputed. Other estimates run from as low as 300 to as high as 30,000). Four hundred and fifty political prisoners remain in custody. Demands for their release and for retribution have increased with the election of a civilian government, but the new government's room to maneuver is limited.

"People expect that on March 11, the 450 political prisoners will be freed right away," said a long-time functionary of the Vicaria de Solidaridad, an affiliate of the Catholic church that documented human rights abuses during the Pinochet years, "and it just isn't going to happen."

The human rights question has the potential to split the governing coalition into two camps, with the Christian Democrats allying with the moderate right, Renovacion Nacional, which is not in the governing coalition, and the Socialists succumbing to pressure from the more radical members of their party. The leader of the Socialist faction in the coalition, Ricardo Lagos, has taken a strong stance, demanding that those responsible for repression be brought to justice.

The Socialists are already frustrated with a complex electoral pro-

cess — designed to favor minority parties — that denied them several key Senate seats even though they won a majority of the vote. They hold only four seats, while Pinochet can appoint nine senators. If Pinochet remains intransigent on the issue of human rights and little progress is made, the temptation for the Socialists to leave the ruling coalition will be great.

The Communists, who kept a very low profile throughout the electoral process, also have a great deal at stake in the resolution of the human rights issue; it is perhaps the one card they have to play. The party was substantially weakened by the repression of the Pinochet years, by its self-isolation at the time of the plebiscite, and now by its confusion in the face of perestroika in the Eastern bloc. It has also remained relatively silent on the economic front, as even the Socialists — often to the left of the Communists in the past — refrain from challenging the nation's free market system.

Finally, there is the issue of elections four years hence. The overriding desire to remove Pinochet from the presidency made it comparatively easy for a wide range of views to unite behind a moderate platform. But by 1993 Pinochet's role will be substantially diminished, and diverse political forces will be much more tempted to re-establish their own identity, making the consensus far more difficult to maintain.

Yet ultimately, Chile's unstable neighbors will remain a force for consensus as will the presence of General Pinochet. Even if individual political groups attempt to reassert themselves, they will have to do so within the framework of a successful free-market economic system that has proven unique on the continent. And the continued presence of Pinochet, even in the wings, serves as a constant reminder that the general may still have the power to protect — if need be — what he believes is his legacy to the Chilean people. □

Update on the Middle East

Judith Kipper

Judith Kipper, a Middle East specialist, is guest scholar at Brookings and senior program associate at the Council on Foreign Relations, where she directs the Middle East Forum. She has recently returned from an extended visit to Egypt, Israel, the West Bank, Jordan, and Syria.

Middle East developments have slipped off the front page, yet the conflicts in the region remain as volatile as ever. A breeze from the Soviet Union and Eastern Europe is passing through the area, but it is too early to assess its impact on the region. The changing global environment is being carefully monitored in the Middle East. Many there believe it could lead to a thaw between Arab states as well as between Israel and the Palestinians.

In today's Middle East, the Israeli-Palestinian conflict remains the most difficult. It is a conflict of legitimate claims — two peoples claiming the same piece of territory, both needing to find a historic compromise that will protect their separate identities and well-being. For more than two years, Palestinians have been resisting Israeli occupation in the West Bank and Gaza Strip. This resistance is now universally referred to by the Arabic word for uprising, *intifadah*. Resistance to occupation is only part of the *intifadah*; another key element is the social revolution that is occurring in Palestinian society.

Israelis who for so long have been victims of Arab rhetoric are confused by the *intifadah* and the determination of the Palestinians. While Israel returned the Sinai to Egypt as part of the Camp David Accords, it is only now that Israel is having to confront the question of land for the Palestinians in exchange for peace. It is only now that Israel has begun to see the Palestinian issue as a political problem.

Israel's remarkable dialogue and restoration of diplomatic relations with the newly democratic states of Eastern Europe coupled with changes in the Soviet Union and the large immigration of Soviet Jews have made the political agenda extremely complicated for Israeli policymakers. Israel's capacity to cope with the demands of these new political issues will severely test its political and economic system. Yet, in Israel, as well as in Egypt, the West Bank and Gaza, a growing pragmatism seems to be guiding these parties who have such an important stake in negotiated solutions.

A breakthrough came a year ago with the recognition of Israel by Yasir Arafat, the leader of the Palestine Liberation Organization. In thinking about the phases that the Middle East conflict has gone through since 1948, it is important to realize that Arafat's action — which is now in the process of being codified — was the public and, hopefully, permanent Palestinian recognition of partition. Equally important but largely unnoticed, the Israelis this past year have accepted the fact that their negotiating partner is not Iraq, Syria, Jordan, or Saudi Arabia, but Palestinians. Which Palestinians has yet to be decided, but the Israelis have nevertheless recognized the Palestinians as their negotiating partner. That is a tremendous step, because Israel has consistently seen the Palestinian issue as a security problem. The Israeli mindset, in both the Labor and Likud parties, is that Palestinians are a security problem rather than a political problem. Israeli willingness to negotiate with Palestinians is a vital step in the peace process.

Keeping these two breakthroughs in mind, a closer look at the situation on the ground in Egypt, Israel, the territories, and Jordan shows some encouraging movement.

Egypt

Egypt's foreign policy has been a tremendous success in the years since the Camp David Accords were signed in 1979. In addition to maintaining its peace with Israel, Egypt has been a staunch ally of the United States, a reliable country committed to solving problems by peaceful means, keeping its word on negotiations, and playing an important role in Africa and the Islamic world. The problem for Egypt today, given the changing global environment, is how to maintain that success. Can Egypt continue to play the same role when its economy is suffering, when there are suggestions that

U.S. aid might be cut, and when the rest of the world has turned its attention to Eastern Europe and other areas.

The birth rate in Egypt is high, a million new babies every eight or nine months. Resources are extremely limited. Water is probably the number 1 problem in the region, but it is not the most interesting. Over the next few years, water is going to be a primary concern throughout the Middle East. It could even be the cause of new conflicts.

Politically, Egypt has begun the process of democratization. But, as an Egyptian scholar said, "We got the hors d'oeuvre, but we never got the main dish." The political climate in Egypt is stagnant. Politics in Egypt today does not stimulate real debate. Opposition parties exist, they are legal, and they all have newspapers. But those opposition parties have been unable to produce the kind of press that would stimulate serious political debate to define the crucial issues. They have been able to criticize the government, but they have not been able to come up with options, alternative programs, or new ideas. Like democratic institutions, government accountability is still in the early stages.

On the peace process itself, Egypt has committed itself to two key aspects of policy — first, that it is never going to use troops, if strategically possible, outside of Egypt's own borders, and second, the Egyptian-Israeli treaty is a permanent fact of life.

Egypt's relationship with Israel is in flux now. Egyptians deal directly with, as they say, the "government of Israel," which is a formal and diplomatic relationship. Egyptians are more comfortable with Labor party people whom they know and can talk with easily. Yet Cairo would be well served by more extensive consultation with the Likud party. Cairo needs to pursue a dialogue with Likud, especially with its younger leaders who are far more worldly than their elders and who have increasing influence on Likud party policy. These Likud leaders are pragmatic, and they show some real promise for the future in terms of a more flexible policy.

The "cold peace" may have served Egyptian purposes until the PLO recognized Israel. Now, this diplomatic distance really works against the interest of peace because Egypt has a clear mandate from the Arab countries, including Syria, to participate in the peace process. Egypt once again is having a positive effect on Arab politics. Obviously, Arab behavior is going to be influenced simply by being allied again with an Egypt committed to negotiated solutions. It is difficult for any country to foment or support radical politics and terror and still maintain a relationship with Cairo. Egypt's handling of the recent terror attack on a bus transporting Israeli tourists made even some hardliners in Israel appreciate this aspect of Egyptian policy.

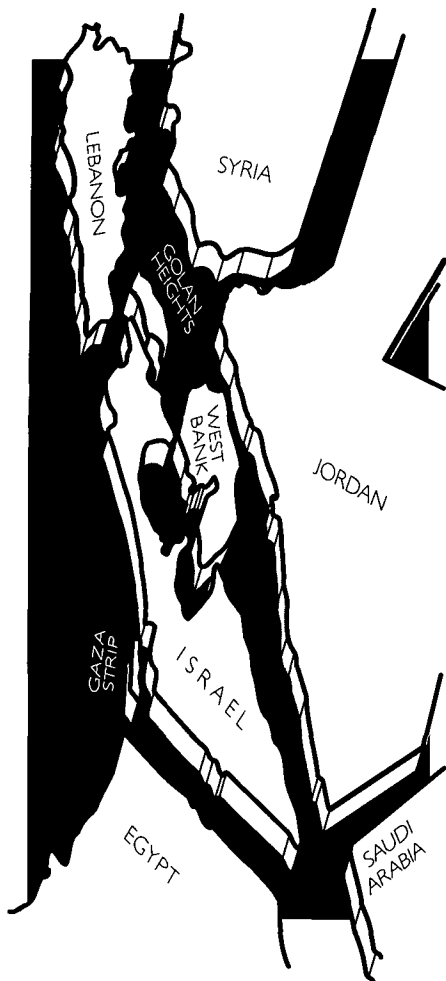
Israel

Debate is also limited in Israel despite political upheavals. Because it does not directly touch their lives, Israelis have gotten used to the *intifadah*. Most Israelis live in the Mediterranean corridor, and they tend to view the West Bank and Gaza as a foreign problem. They don't go there, they don't know much about conditions there, and they can't watch it. Israeli censorship of television coverage in the West Bank and Gaza has been effective.

Casualty figures for Palestinians in the territories show that the *intifadah* has not declined. The number of Israelis who have been killed or injured remains small. Sadly, the situation has not become intolerable for the majority of Israelis. Peace Now is active, organizing marches, human chains around the old city, and over the long term that kind of activity certainly builds bridges between the two communities, but so far these political moves have not succeeded in dramatically altering Israeli attitudes.

The one bright spot is the immigration of Soviet Jews. They are a source of tremendous joy and excitement, and well they should be, for in 1990





when there is a need, Jews have a safe haven. This is a non-Zionist immigration. Soviet Jews are coming because of economic conditions and anti-Semitism in the Soviet Union. The future there is uncertain. With inspired leadership in Israel, this immigration could be a chance for Israel to be reborn again, to be the Jewish democracy and the safe haven, "a light unto nations," that its original founders intended.

The absorption of Soviet Jews is going to be extremely messy, because as one government minister said, "Israel is a messy country." Of the 173,000 Jews who have come to Israel in the last two decades, 93 percent have stayed in Israel proper. Virtually, none has left the country. Soviet Jews arriving now are highly educated people — engineers, doctors, lawyers — who don't want to live in the territories; they prefer to live in apartments in Tel Aviv or in Jerusalem. Over the long term, this immigration could create an economic boom for Israel — inside Israel — not in the territories. Apartment prices will go up, building will begin again, shops will open, and Israel will find the funds to absorb Soviet Jews, even if there are a million of them over 10 years.

The question is how to interpret this immigration — probably the last massive one that Israel can expect — in terms of modern Zionism for the Jewish state. Soviet Jews may give Israel the strength necessary to live at peace in its neighborhood. Politically, Soviet Jews are likely to identify with the right, at least initially. In the short term Soviet Jews may be Likud voters because they are anti-socialist.

Apart from the immigration of Soviet Jews, Israel is going through a painful ethnocentric phase. Israelis, whether on the left or the right, seem unaware that their statements, their claims, particularly the Israeli notion that Jordan is Palestine, have an impact on Israel's neighbors. They don't seem to understand that their words create fear, nervousness, distorted perceptions on the other side. Israelis are resentful about the concessions they believe they are being asked to make. They have real fears about the nature of the problem they are facing, and they lack the leadership that is likely to get them out of the dilemma they find themselves in.

The Territories

Since last year, a change for the better has taken place in the territories, though they are like a burning island between Jordan and Israel. Israelis no longer go into East Jerusalem or the West Bank or Gaza unless they live there or have official meetings with Palestinians. On the other hand, Palestinians have decided that they may have made a mistake focusing on Washington all these years and that they can change the current stalemate only if they change Israeli public opinion. So Palestinians are going to Haifa, to Tel Aviv, to kibbutzim, to every place they are invited, to meet with Israelis. Professors at Tel Aviv University, at the Technion University in Haifa, and elsewhere are inviting Palestinian scholars to speak to friends. Palestinian women are meeting with Israeli women in auditoriums, schools, kitchens, at women's groups, and the dialogue between them is quite extraordinary.

The level of dialogue and knowledge throughout the territories is high. Take, for example, the Dheishe refugee camp outside Bethlehem. It is surrounded by two chain link fences that are 10 or 15 feet high with a moat in between filled with putrid water and garbage. Ten thousand people live in this camp and there is only one exit. Few people have cars, there are only a few telephones inside the camp. Some of these Palestinian refugees can't read and write; they're living in poor conditions. Yet they talk about Noriega, about Ceausescu, about Secretary Baker's peace plan, about the PLO. The attitudes in the refugee camps and the level of knowledge have improved. Throughout the West Bank and Gaza there has been a change in

attitude, which signals the beginning of political maturity.

One reason Palestinians are well informed is that after dark, no one in the territories, even in East Jerusalem, goes out — even when there is no curfew. People stay home, talk politics, read the papers, and watch television. Many of these people speak enough Hebrew or understand it well enough to watch Israeli news. They also watch Jordanian television in Arabic, so they are well-informed.

What is most impressive in the territories, particularly in the camps, is the thousands, perhaps tens of thousands of youngsters, males, from 15 on up who have nothing to do. Many of the high school kids will not go to school because they are afraid that Israeli soldiers will pick them up. Those who have graduated from high school cannot find jobs, and universities are closed. There is a huge group of people, young boys, with nothing to do; they simply hang around. And most have a prison story.

The harshness of the Israeli Defense Force and the excessive use of force have become facts of life, as the human rights report of the State Department documents. Palestinians go to prison, and they come out stronger. They are more determined, more calm, more knowledgeable. Prison has become a school for politics. And as the sense of humiliation diminishes, the sense of dignity grows. After all, humiliation is a self-perception. Natan Sharansky and Nelson Mandela did not feel humiliated because they decided, that no matter what was done to them, they were not going to be humiliated. The same thing is happening now in the territories. This confuses the Israelis because they are still looking at Palestinians, especially young males, as a security risk.

Yet, despite events, Palestinian society in the West Bank is stable, perhaps less so in Gaza because of economic conditions. Life goes on. But the Palestinians are isolated, they are lonely. Yet, they are not going to go anywhere or do anything without the PLO in the foreseeable future.

Jordan

Jordan, of course, is an important partner in any Israeli-Palestinian peace settlement. Since Jordan disengaged from the West Bank of the Jordan River — territory lost to Israel in the 1967 war — it has focused on East Bank issues. Elections in November 1989 have produced a new atmosphere in Jordan. A frustrated and sometimes resentful population is now engaged in open democratic debate in Jordan's parliament and press. This transition will lead to the establishment of political parties and to economic reforms in Jordan. In geopolitical terms, Jordan's political developments are being closely watched by its neighbors and are a potential important influence. The state of Jordan is in the process of developing a national political life, which will enable it to join in Israeli-Palestinian negotiations at an appropriate time.

The lack of real organization to cope with the changes in the Middle East has perhaps become a major obstacle to progress toward peace or economic development. Interpreting Islam for the 21st century requires visionary leadership. Until recently, there has been no real democratic alternative in the Arab world, and many in the region are asking if Islam can cope with modernity to encourage the development of secular political institutions.

For Israel, leadership is also a key question. The most formidable and determining factor in the lives of Israel's current leaders was World War II. This historical trauma and its impact on Israel's national life must be taken into consideration to understand the meaning of Zionism in modern times.

The wounds of the bitter wars and the deprivation of decades for both Israelis and Arabs need time to heal. Thus, the key question both in Israel and in the Islamic countries of the Middle East is how do they get from here to there while new leadership emerges and their societies mature. □

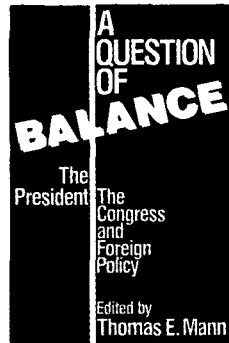
Thus, the key question both in Israel and in the Islamic countries of the Middle East is how do they get from here to there while new leadership emerges and their societies mature.

Making Foreign Policy

A Question of Balance: The President, the Congress, and Foreign Policy

Edited by Thomas E. Mann

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The extraordinary changes sweeping through Eastern Europe, the accelerated globalization of economic activity, and the growing importance of new international issues such as the environment and drugs all leave little doubt about the need for a fundamental restructuring of American foreign policy. Less certain is whether our contemporary institutional arrangements for making foreign policy are up to the task. In recent years an active and aggressive Congress has often sharply disagreed with the president over the objectives and methods of foreign policy.

This conflict has its roots in the constitutional partnership between the two branches, but it has been exacerbated by the modern pattern of split-party control of the branches.

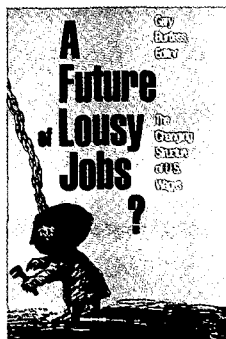
The authors of *A Question of Balance* explore the sources and patterns of the modern conflict. Looking specifically at recent disputes between the president and Congress on war powers, intelligence, arms control, trade, and diplomacy, they conclude that the balance between the two branches required to set effective foreign policy has been seriously skewed. Restoration of the balance will entail a recognition and strengthening of each branch's comparative advantages and an acknowledgment that neither branch can operate effectively without the cooperation of the other. A return to balance will require the president's acceptance of a truly collaborative approach to foreign policy, changes in the institutional arrangements through which the branches interact, and a principled and responsible defense of both presidential and congressional prerogatives. It will also require the development of new policies that can attract broad support among foreign policy specialists and the general public.

Low Skills, Low Wages

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In recent years public concern has grown over the decline — or perceived decline — in middle-class jobs. The U.S. economy has produced more than 35 million jobs since 1973, a record that is the envy of other industrialized nations. But many workers and policy-makers are convinced that too many of these jobs pay too little to sustain a middle-class living standard.

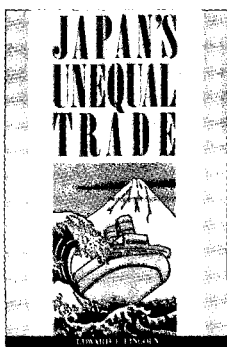
Edited by Brookings senior fellow Gary Burtless, *A Future of Lousy Jobs?* addresses two main issues. It examines the changing distribution of U.S. jobs and seeks to determine whether recent employment

growth has been disproportionately concentrated in low-wage jobs. And it attempts to establish the main economic causes behind the drift in the American wage structure.

The authors, all labor economists, conclude that wages have become more unequal over the past decade, largely because of the steady rise in wage inequality among men. Young men and men with little formal education have been particularly affected by the changing wage structure. Several groups actually suffered substantial losses in real earnings.

Two factors seem to be important. First, the changing industrial structure of the labor force has seriously harmed the job prospects of less skilled men, particularly those with little previous work experience. Second, in industry after industry, employers have changed the way work is done. As a result, workers with extensive skills, formal education, and prior work experience have prospered; workers with limited skills, education, and experience have suffered. A long-range solution to this imbalance will require upgrading the skills of workers now at the bottom of the wage structure.

Trading with a Changing Japan



Trade relations between the United States and Japan have generated much heated debate in recent years. Even the core of the problem is a subject of disagreement: is it Japan's global trade surplus, the bilateral trade imbalance, or competitive practices in particular markets? Is it mainly American practices or Japanese practices that are responsible for the lopsided imbalances?

In *Japan's Unequal Trade*, Edward J. Lincoln focuses on the unusual patterns that have characterized Japanese trade; compared with other industrial nations, the country has a low level of manufactured imports and a relative absence of the two-way flow within particular industries known as intra-industry trade. Lincoln argues that these unusual features are the result of attitudes, policies, and institutions that emerged from Japan's determined effort to catch up with the West. Now that Japan has joined the ranks of the advanced industrial nations, these features of the economy have proved to be difficult to change.

Since 1985, however, the large appreciation of the yen against the dollar has prompted the Japanese to reassess their import policy and the country's economic relationship to the world in general. Lincoln, a senior fellow in the Brookings Foreign Policy Studies program, argues that American trade policy toward Japan must incorporate this new atmosphere. Now is not the time to abandon the liberal trade principles embodied in the GATT for a system of managed trade. Sanctions or other harsh negotiating tactics may be necessary occasionally, Lincoln writes, but they should be applied carefully and rationally.

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